Sulzberger

Supreme Court of the United States,

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,
Plaintiff in error,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF IN ERROR.

WILLIAM D. GUTHRIE,
LANGDON P. MARVIN,
HENRY M. WARD,
HERBERT POPE,
RUSH C. BUTLER,
Of counsel for plaintiff in error.

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BRIEF FOR PLAINTIFF IN ERROR.

This case comes before the court on writ of error to the District Court of the United States for the Southern District of New York to review a judgment entered on December 17, 1920, sustaining a demurrer to the complaint on the ground of insufficiency. The facts pleaded and all inferences of fact to be drawn from the facts pleaded are, therefore, admitted. The plaintiff in error was plaintiff below.

STATEMENT.

The complaint on its face presents the same question of constitutional law as is presented in *Merchants' Loan and Trust Company* v. *Smietanka*, No. 608, and *Eldorado Coal and Mining Company* v. *Mager*, No. 609, of the present term, now under advisement, and also involved in *Walsh* v. *Brewster*, No. 742 of the present term, namely, whether the growth or increment in value of property held for investment and constituting part of the taxpayer's capital, is, when realized by the sale

or conversion of such property, taxable as income under the Sixteenth Article of Amendment to the Constitution of the United States. The case also presents the question of construction of the Income Tax Law of 1916, as to whether or not a gain realized upon such sale by an individual investor is included within the terms of that act as an item of taxable income. The case further presents a question of construction, not involved in the other cases now under advisement, as to whether, when a loss has in fact been sustained by the taxpayer upon the sale of property acquired prior to March 1st, 1913, he is nevertheless taxable upon the difference between the price realized upon the sale and the value of the property upon March 1st, 1913, the selling price being lower than the price or value at the time of actual acquisition. In *Walsh* v. *Brewster* similar questions are involved with respect to investments acquired in 1899, and 1906, and sold in 1916, some at a profit and others at the same price at which they were purchased prior to March 1, 1913.

The plaintiff made his return and paid a tax on his concededly taxable income on May 10, 1917; but the Commissioner of Internal Revenue assessed an additional income tax, and the defendant made demand for payment of this additional tax on May 6, 1920. The plaintiff paid under duress and protest on May 15, 1920, the sum of $3,490.87 on account of the additional tax so assessed (record, p. 6). On August 6, 1920, the plaintiff filed his application for a refund of the additional tax so paid, which was denied by the Commissioner on October 26, 1920, and this action was thereupon duly brought against the Collector (pp. 6, 10).

The proceeds of the sale of two lots of securities are involved. Of the total of the tax of $3,490.87 so paid un-

der said reassessment, the sum of $2,145.91 was based upon alleged income in the form of alleged gain amounting to the sum of $120,710.75 claimed by the Commissioner to have been derived by the plaintiff from the sale in 1916 of 3,600 shares of the common stock of the B. F. Goodrich Company, a New York corporation (pp. 6, 7-8), and the remainder (viz. $344.96) was based by the Commissioner upon alleged income in the form of gain amounting to $13,236.22, derived by the plaintiff from the sale in 1916 of 1,000 shares of stock of the United Verde Extension Mining Company bought in 1912 as an investment (pp. 6, 9).

It was conceded below in and by the demurrer that the plaintiff was not at any of the times alleged in the complaint "in any sense engaged in the business of buying or selling stocks, bonds, or other securities" (p. 5); that the shares of capital stock of the Goodrich Company were received by him in May, 1912, upon a reorganization, in exchange for stock acquired by him in or prior to 1907 partly through gift and partly through inheritance from his mother, and that the shares of the Mining Company were acquired in 1912 through subscription and purchase for investment (pp. 7, 9). The questions presented, therefore, arise solely in connection with property held as investment and in no sense, as the demurrer admits (p. 5), in connection with the transaction of a trade or business.

The facts with respect to the stock of the Goodrich Company are as follows (pp. 7-9):

The plaintiff's father, B. F. Goodrich, died in August, 1888, owning several thousand shares of stock of the B. F. Goodrich Company, a corporation of the State of Ohio. By his will he bequeathed this stock to his

widow, the plaintiff's mother. During her lifetime she gave the plaintiff a part of the shares of said stock, and on her death in 1907 bequeathed to him by her will other shares of said stock. The plaintiff continued to hold the same until May, 1912, when the Ohio Company was reorganized, and the business and assets transferred to a new corporation organized under the laws of the State of New York with the same name. The plaintiff thereupon exchanged his shares of stock in the Ohio corporation for shares of stock in the New York corporation and cash. On the date of such exchange, shares of this stock in the New York corporation were of the fair market value of $81 per share. The plaintiff sold 3,600 shares of said stock of the New York Goodrich Company, so received by him in May, 1912, on various dates in 1916 between February and July, at a total price of $269,346.25, the average price received on said sales being $74.82 per share, and the prices being in each instance less than $81 per share. The total value of the said 3,600 shares in May, 1912, was $291,600, and the plaintiff upon the sale thereof received $22,253.75 less than such value. On March 1, 1913, certain shares of said stock were sold on the New York Stock Exchange at an average price of about $41.25 per share. The Commissioner of Internal Revenue on this basis computed and determined the total fair market value on March 1, 1913, of the 3,600 shares so sold to be $148,635.50, and held that, with respect to the sale of said 3,600 shares of stock, the plaintiff in the year 1916 received a taxable gain equal to the difference between the market value of said stock on March 1, 1913, viz., $148,635.50, and the total sale price in 1916, viz., $269,346.25, and was, therefore, taxable on the sum of $120,710.75 as "net income."

With respect, consequently, to the shares of stock of the Goodrich Company, there was no growth or increment or accretion or gain whatever in value from the time of acquisition by the plaintiff until the time of sale, but, on the contrary, a depreciation or shrinkage in value, liquidated upon the sale in the sum of $22,253.75, which in fact constituted a loss to the plaintiff.

The facts with respect to the sale of the shares of stock of the United Verde Extension Mining Company are as follows (p. 9):

During the year 1912 the plaintiff subscribed for and bought for investment 1,000 shares of the capital stock of said mining company at fifty cents per share, making a total purchase price of $500, and on March 7, 1916, sold them for the sum of $13,931.22. On March 1, 1913, the stock of said mining company was quoted on the New York Stock Exchange at an average price of 69½ cents per share, and the Commissioner found this price to be the fair market value of said stock as of March 1, 1913, and the total market value on said date of said 1,000 shares to be $695. The Commissioner thereupon assessed an income tax against the difference between said valuation on March 1, 1913, and the sale price realized, amounting to $13,236.22, such sum representing the growth or increment in value of said investment from March 1, 1913, to the date of sale, March 7, 1916, and with respect to the same the plaintiff paid a tax of $344.96 (p. 6).

The controlling and conceded facts in the case at bar are, therefore, (1) that the plaintiff acquired and at all times held the securities in question as investments, and not in connection with the transaction of any trade or business carried on for gain or profit, (2) that on the

Goodrich Company's stock there was no gain whatever but an actual loss or dimunition of capital growing out of the ownership or use of or interest in such property, and (3) that the gain or profit realized on the Mining Company's stock was the result of the growth, increment, or increase in value of a capital asset owned and held for investment since 1912.

In an appendix to this brief the relevant and pertinent provisions of the Income Tax Laws of 1913 (38 Stat. 166) and 1916 (39 Stat. 756), are printed in parallel columns with appropriate variations of type to denote the difference in phraseology.

Assignment of errors.

1. That the court below erred in sustaining the demurrer of the defendant.

2. That the court below erred in ruling that the said Act of Congress of September 8, 1916, as construed by it, was constitutional and within the taxing power delegated to Congress in and by the Sixteenth Article of Amendment to the Constitution of the United States.

3. That the court below erred in ruling that any part of the proceeds of the sale of the shares of the capital stock of the Goodrich Company constituted net income taxable under said Act of Congress.

4. That the court below erred in ruling that any part of the proceeds of the sale of the shares of the capital stock of the United Verde Mining Company constituted net income taxable under said Act of Congress.

I.

Review of prior statutes and decisions of the court.

Before discussing the question of the true meaning and scope of the term "incomes, from whatever source derived" contained in the Sixteenth Article of Amendment to the Constitution of the United States and its equivalent in the Act of 1916, it may be useful to review the prior statutes and decisions of this court in cases which involved questions of increase in value of capital investments. These cases arose respectively under three taxing laws of Congress, viz., (1) the Income Tax Act of 1867 (14 Stat. 471, 478, c. 169), (2) the Corporation Excise Tax Act of 1909 (36 Stat. 11, c. 6), and (3) the Income Tax Act of 1913 (38 Stat. 166, c. 16).

(1) The Income Tax Act of 1867 provided as follows (p. 478):

> "That there shall be levied, collected, and paid annually upon the gains, profits, and income of every person residing in the United States, or of any citizen of the United States residing abroad, whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, carried on in the United States, or elsewhere, or from any other source whatever, a tax of five per centum on the amount so derived over one thousand dollars, and a like tax shall be levied, collected, and paid annually upon the gains, profits, and income of every business, trade, or profession carried on in the United States by persons residing without the United States, and not citizens thereof. And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first day of December next preceding the time for levying, collecting, and paying said tax. . . .

> "In estimating the gains, profits, and income of any person, there shall be included all income derived from interest upon notes, bonds, and other securities of the United States; profits realized within the year from sales of real estate purchased within the year, or within two years previous to the year for which income is estimated; . . . all other gains, profits, and income derived from any source whatever."

This court held in *Gray* v. *Darlington*, 15 Wall. 63, that the provisions above quoted did not include or tax an advance in the value of property during a series of years, although the entire amount of the advance had been realized in the taxable year by a sale of the property and conversion of the investment into money. Mr. Justice Field, delivering the opinion of the court, among other things, said (at p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital."

In so deciding the court reached the same conclusion by substantially similar reasoning as was reached by the courts in England in construing the Income Tax Law of that country and it likewise recognized, as the English courts have done, the distinction between a trader and merchant on the one hand realizing a gain or profit in his business and an investor on the other hand realizing a gain or profit on an isolated transaction unconnected with his trade or business, which distinction is fully discussed in the cases cited below under point II.

In *Lynch* v. *Turrish*, 247 U. S. 221, the court followed *Gray* v. *Darlington*, and quoting from that case among other things said (at p. 230):

"This case has not been since questioned or modified.

"The Government feels the impediment of the case and attempts to confine its ruling to the exact letter of the Act of March 2, 1867, and thereby distinguish that act from the Act of 1913 and give to the latter something of retrospective effect. Opposed to this there is a presumption, resistless except against an intention imperatively clear. The Government, however, makes its view depend upon disputable differences between certain words of the two acts. It urges that the Act of 1913 makes the income taxed one 'arising or accruing' in the preceding calendar year, while the Act of 1867 makes the income one 'derived'. Granting that there is a shade of difference between the words, it cannot be granted that Congress made that shade a criterion of intention and committed the construction of its legislation to the disputes of purists. Besides, the contention of the Government does not reach the principle of *Gray* v. *Darlington*, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as 'arising or accruing', to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

(2) It is not necessary to quote the language of the Corporation Excise Tax Law of 1909. As has been repeatedly pointed out by the court, that act "was not in any proper sense an income tax law, nor intended as such, but was an excise upon the conduct of business in a corporate capacity, the tax being measured by reference to the income in a manner prescribed by the act itself" (*Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69, 72, citing previous cases.) Hence, it follows that the decisions under the Act of 1909 are not in point as to the

true meaning of the term "income" in an income tax statute or constitutional provision. The excise upon the conduct of business in a corporate capacity could properly be measured by either capital or income, gross or net, and include in such measure or standard, items not in their essence income at all. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. This fully distinguishes the cases arising under the Act of 1909, such *e.g.* as *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, and *United States* v. *Cleveland &c. Ry. Co.*, 247 U. S. 195. Moreover, the Act of 1909 was construed by this court in these cases as taxing corporations not upon all income received during the taxable year but "by a measure based upon the gainful returns from their business operations and property *from the time the act took effect*" and "conveying rather the idea of gain or increase *arising from corporate activities*" (*Doyle* v. *Mitchell Brothers Co.*, at pp. 183 and 185), and therefore as *excluding income that accrued before that date* (*Hays* v. *Gauley Mountain Coal Co.*, at p. 192). In thus construing the Act of 1909 as excluding gains or profits or income accruing prior to January 1, 1909, the court was not defining the term "income" in any sense beyond that applicable to the construction of the act then under consideration, nor was it intimating that increase in value of capital assets accruing prior to January 1, 1909, would not be income whilst a similar increase in value accruing after that date would be income. The Act of 1909 would have levied a constitutional excise tax if it had been measured by the entire receipts or the gross income of corporations without regard to when gains or profits had accrued, for what was taxed was not gains or profits or income as such but "the particular privilege of

doing business in a corporate capacity" (*Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 151). Therefore, the fact that Congress saw fit to adopt a measure for the excise tax it then levied, which included only gains accruing after a fixed date and excluded those accruing before that date, has little or no logical bearing or relevancy upon the question as to what does or does not constitute "income" within the meaning of the Sixteenth Amendment or within the intent of Congress in levying a direct tax without apportionment upon "incomes, from whatever source derived." The Corporation Tax of 1909 was expressly sustained only upon the ground that it was not in any respect a direct tax; or stated in other words, it was sustained only because it was an excise and not an income tax within the meaning of the latter term as commonly and currently understood and as passed upon in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601. Of course, the selling of property by a corporation whether at a profit or a loss was the doing of business in a corporate capacity, and it was immaterial that the property sold was held by the corporation as a separate investment.

The point that the word "income" in the Act of 1909 meant gain or increase arising solely from corporate activities is further elucidated by the opinion of the court in *McCoach* v. *Minehill & Schuylkill Haven R. R. Co.*, 228 U. S. 295, 305-306, where it was held that the tax was not imposed upon a corporation not engaged in active business, though in the receipt of a large net income.

The recent Income Tax Laws have specifically dealt with *net* income, and in no case have they sought to tax the gross receipts or gross income of the taxpayer. Thus, in one clause of section 1 of the Act of 1916 the phrase

is "entire net income" (*a*), whilst in the following clause it reads "total net income" (*b*), but both refer to such part of the proceeds of sales, or dealings in real or personal property as does not represent capital but is independently "derived from capital, from labor, or from both combined." A tax on gross income from all sales would not be valid as an income tax,* although a tax would be valid if levied as an excise tax on the carrying on of a business or trade or profession, measured by gross income. *Spreckels Sugar Refining Co.* v. *McClain*, 192 U. S. 397, 413.

(3) The Income Tax Act of 1913, the first Income Tax Law under the Sixteenth Amendment, provided in par. A, subdiv. 1 (38 Stat. 166, c. 16) as follows (see appendix):

> "That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year." . . . etc.

It will be noted that in the Act of 1913 as well as in the Sixteenth Amendment, substantially the same formula was adopted as was contained in the Act of 1867. The phrase "all income derived from any source whatever" in the Act of 1867 became "incomes, from whatever source derived" in the Amendment, and the phrases levying the tax in the Acts of 1867 and 1913 are substantially and in effect the same, and especially so in the feature that the tax was to be levied "*annually* upon the entire net income arising or accruing from all sources in the preceding calendar year." The substitution of the words "arising or accruing" for the term "derived" involved but a negligible "shade of difference," as was pointed out in *Lynch* v. *Turrish*, *supra*.

As we have seen, the Act of 1913 came before the court

* In *Nicol* v. *Ames*, 173 U. S. 509, 521, the court recognized that a tax on all sales would be "really and practically upon property."

for construction in *Lynch* v. *Turrish,* 247 U. S. 221, in a case involving an advance in value of corporate assets and the distribution of the proceeds among the stockholders. It was then held that the rule in *Gray* v. *Darlington* applied and was controlling, clearly upon the ground that the provisions of the Act of 1913 were substantially the same as those of the Act of 1867, and that a mere advance in value realized on the conversion into money of an existing capital investment did not constitute income within the meaning of either act. It is true that the gain or profit in that case actually accrued before the Act of 1913 became effective, but that feature was emphasized only as bearing upon the intent of Congress and the construction of the statute. There is nothing in the reasoning of the opinion to indicate that, in the opinion of the court, if the advance had taken place or accrued after March 1st, 1913, the nature of the item would have been thereby changed from capital into net income and a different rule of law have been applicable. If in its nature essentially capital before the Act of Congress or the adoption of the Amendment, it certainly must continue to be capital thereafter. This should follow quite clearly and indisputably when it is recalled that in the cases of *Lynch* v. *Hornby* and *Peabody* v. *Eisner,* 247 U. S. 339 and 347, both argued at the same time as *Lynch* v. *Turrish,* and decided on the same day, it was held that it was immaterial and irrelevant that a surplus out of which corporate dividends were paid or payable had accumulated prior to the Act of 1913, because dividends from investments in stock "are commonly reckoned as dividends, and are expended as such by the stockholders without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation" (p. 344). The

basic and controlling difference between the two classes of cases was that in those like *Lynch* v. *Turrish* the transaction was not the declaration and payment of a dividend in the common understanding of that term or in the ordinary course of the business of a corporation, but was a conversion or transmutation of capital assets into money for final distribution among stockholders as capital, whilst in cases like *Lynch* v. *Hornby* and *Peabody* v. *Eisner*, the transactions constituted the declaration and payment of dividends in the ordinary, current and common acceptation of that term, and it was quite immaterial when the net earnings out of which the dividends were paid or payable had accrued to the corporation.

The case of *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, also arose under the Act of 1913. The facts were peculiar, but the fundamental inquiry was as to the nature of accumulations and increase in value of corporate assets prior to January 1st, 1913. The Government contended that as a dividend of the amount of these accumulations had actually been declared and practically paid in 1914, it constituted part of the corporation's gross "income" in the sense of something coming in, realized, received, arising, or accruing during the taxable term, and could not, therefore, be treated as capital assets instead of income. Answering this contention, the court said (at p. 335):

> "We must reject in this case, as we have rejected in cases arising under the Corporation Excise Tax Act of 1909 (*Doyle* v. *Mitchell Brothers Co., ante*, 179, and *Hays* v. *Gauley Mountain Coal Co., ante*, 189) the broad contention submitted in behalf of the Government that all receipts —everything that comes in—are income within the proper definition of the term 'gross income', and that the entire proceeds of a conversion of capital assets, in whatever form and under whatever cir-

> cumstances accomplished, should be treated as gross income. Certainly the term 'income' has no broader meaning in the 1913 Act than in that of 1909 (see *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 416, 417), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer." (See also *Gulf Oil Co.* v. *Lewellyn*, 248 U. S. 71.)

There can be no doubt that if increase or increment in value of a capital investment became income whenever realized by conversion into money or other property, or in other words, if what was essentially a part of capital was changed in its nature and substance by the mere act of conversion or realization, the conclusions reached in the cases of *Gray* v. *Darlington*, *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, were erroneous.

As discussed below, an examination of the Acts of 1913 and 1916 will show that Congress had clearly in mind that gains and profits or losses resulting or accruing from the trade or business of a taxpayer were to be regarded and treated as distinct and separate from gains and profits or losses resulting or accruing from isolated transactions* or capital investments not connected with the carrying on of any trade or business. The Act of

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* The phrase "isolated transactions," to characterize transactions separate and apart from a taxpayer's regular trade or business, seems to have originated in a ruling of the Treasury Department under the Act of 1913 (Treasury Decision 2090, December 14, 1914). It may at times be difficult to determine what are or are not isolated transactions; but the question of fact is being constantly and necessarily passed upon by the Department, and similarly the question as to what are and are not "transactions entered into for profit," within the meaning of that phrase introduced in the Act of 1916. *Mente* v. *Eisner*, 266 Fed. 161; certiorari denied October 11th, 1920.

1916, moreover, for the first time introduced among the provisions as to allowable deductions, the following:

> "Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom."

Clearly, if Congress had not then had in mind the subject of gains and profits or losses resulting from transactions independent of business or trade, no such provision would have been inserted. It will further be noted that reference was made not to all transactions of the taxpayer not connected with his business or trade, but only to those "entered into for profit," language which plainly differentiated investments acquired for income from more or less speculative "transactions entered into for profit."

Under the Act of 1916, therefore, every taxpayer had to cover in his income tax return and the Government was called upon to investigate and differentiate the following among other items:

(1) The entire net income received or derived from any source whatever.

(2) Net income received from "the transaction of any business carried on for gain or profit."

(3) Losses actually sustained during the year, "incurred in his business or trade."

(4) Losses actually sustained during the year "in transactions entered into for profit but not connected with his business or trade. . . . to an amount not exceeding the profits arising" from similar transactions.

Capital losses, however, were not generally allowed to be deducted, because, it is proper and reasonable to infer, under neither the Act of 1916, nor the Act of 1913

upon which it was based, was it intended to tax the proceeds of capital assets sold at an increase over their cost any more than such proceeds were taxed under the Act of 1867.

The Government concedes that, of course, nothing is now income which was not income before the adoption of the Sixteenth Amendment and that mere increase in value, while it remains such, is not income but still capital. It urges, however, that an amount equal to any increase in value of property held for investment becomes income as soon as and whenever the investment is converted into cash or into other property. In other words, the contention is that although the entire investment is clearly capital while unconverted, a part becomes income upon conversion to the extent of any realized gain or profit.

The fundamental difference between the Government and the plaintiff is principally one of definition. If the term "incomes" in the Sixteenth Amendment and the statutes now in question means "all receipts—everything that comes in," then clearly even the proceeds of investments sold at a loss would be receipts and would be money coming in. This view having been rejected as unsound, a narrower sense or meaning of the term "income" must necessarily be accepted. The Government, therefore, suggests a meaning which it alleges obtains in current speech and common understanding, and contends that such meaning includes the realization by sale or conversion of increase in value of property held for investment.

There are three definitions by the court itself, as a result of the process of inclusion and exclusion, to which reference should be made, viz.:

> (1.) "Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated

merely as increase of capital" (*Gray* v. *Darlington*, 15 Wall. at p. 66).

(2.) "Advance in value is not income at all, but merely increase of capital and not subject to a tax as income" (*Lynch* v. *Turrish*, 247 U. S. at p. 231.)

(3.) "Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *'derived'*, that is, *received or drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from properties. Nothing else answers the description. . . . Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term" (*Eisner* v. *Macomber*, 252 U. S. at pp. 207 and 214-5).

See also the cases cited below under point II as to the interpretation of the term "income," including *Smith* v. *Hooper*, 95 Md. 16, 26-31, where the Supreme Court of Maryland said:

"The word 'income' . . . is not synonymous with 'increase'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. The conversion of some of the shares into money resulted merely in substituting the cash received for the shares thus sold; and if the unsold shares represented nothing but capital, though capital of a largely increased value, the money obtained for the shares when sold can represent nothing but capital either. . . . That there has been a marvelous increase of the fund is manifest. Is that increase *income?* Increase and income are not synonymous terms. Until detached or separated from the shares whose value it enhances increase forms part of that value, and, therefore, part of

the shares and if it be part of the shares themselves then, whilst it may be *profit*, it is in no sense income."

It is true that there are various other dictionary meanings of the term "income", some broad and some narrow and some usual and others rare or obsolete; but the current meaning in common speech is what the court has recognized and stated in the above quotations. A man not engaged in the business of buying and selling, say, real estate, who has held such property, it may be his home, for a series of many years, and who then sells it at an increase over what he paid, would not reasonably or sensibly regard or treat the gain thus made as income. He would not ordinarily include any part of the proceeds of such an isolated transaction, perhaps the only one of its kind in many years or a life time, as part of his annual income. On the contrary, if commonly prudent and conservative, he would regard and treat it as still an integral part of his permanent capital, to be used, if necessary, to offset or meet past or future capital losses, or to replace what he had sold with property equal in value or producing equal income.

Again: a man not engaged in the business of dealing in bonds and stocks, who had purchased securities for investment and not for speculation, who looked for safety of investment and certainty of return and not for profit on a sale or conversion thereof, would not reasonably or sensibly regard or treat an increase in value of a particular security when realized by sale or conversion, as part of his annual income. On the contrary, if ordinarily cautious and conservative, he would regard and treat it as still an integral part of his capital, to be used, if necessary, to offset and meet past or future depreciation and

capital losses in respect of other securities, or to replace what he had sold with other income producing securities.

Or, to take the case of an inheritance: a man inheriting a homestead or securities (as the plaintiff inherited the Goodrich stock in the case at bar) and years afterwards selling the same, could not reasonably regard or treat any part of the proceeds as income accruing during the year of the sale. It would all be still part of the capital he had inherited, and no part of it would be income within any reasonable meaning or acceptation of the term.

Stated in other words, the current meaning of the word "income" in common speech and according to common understanding is the return or gain which is periodically or annually derived from capital or from labor or from both combined, and not the extraordinary gain or profit which may be derived from an isolated sale of property held through a series of years for investment and in no sense connected with the taxpayer's business or bought by him for speculation or profit. Such an increase in value of an investment unrealized is always and properly regarded by private investors as essentially part of capital, and they do not regard or treat it as changed into income merely because it has been converted into money, it may be for the sole purpose of substituting another income-producing investment.

The authorities discussed below, it is submitted, establish the correctness of this conception of the current meaning and understanding of the term "income" as used in the Sixteenth Amendment and the Act of 1916.

II.

The growth or increment in value of real or personal property held for investment, when realized by sale, is not "income" within the meaning of the Sixteenth Amendment.

The Sixteenth Article of Amendment to the Constitution of the United States, which was declared to be duly ratified on February 25, 1913 (37 Stat. 1785), provides as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Sixteenth Amendment added nothing to the subject matters theretofore taxable by the Congress, but merely dispensed with the requirement of apportionment as to one class of direct taxes, namely, taxes on incomes derived from the ownership of property. It clearly limits the taxing power of Congress thereunder to "incomes", and it does not authorize or permit an unapportioned tax levy upon capital in any form whatever or under any device. A tax levy that takes part of the principal or capital of a property asset of the taxpayer is necessarily a tax on property as distinguished from a tax on income derived from property, and is consequently a direct tax, which must constitutionally be apportioned. The reasoning which supports this conclusion is comprehensively and accurately stated by Mr. Justice Van Devanter in *Evans* v. *Gore,* 253 U. S. 245, 261-3, and by Mr. Justice Pitney in *Eisner* v. *Macomber,* 252 U. S. 189, 206. In the latter case, the learned Justice reviewed the effect and scope of the Sixteenth Amendment in the following language:

"As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income. *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 17-19; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112, *et seq.; Peck & Co.* v. *Lowe*, 247 U. S. 165, 172-173.

"A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overriden by Congress or disregarded by the courts.

"In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter may also have proper effect, it becomes essential to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

The requirement of apportionment imposed in and by sections 2 and 9 of Article I of the Constitution, therefore, remains in undiminished force and effect in respect of everything theretofore embraced within it, except only as to "taxes on incomes." Direct taxes on *capital* and the *proceeds* of capital still may not be constitutionally laid without apportionment. *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 637. The extent to which the Constitution remains operative in this relation, and the

extent to which the Amendment must be accorded supervening effect, are both to be determined only as it is made apparent what is "income" and what is not "income", within the meaning of that term as employed in the Sixteenth Amendment and in the light of the fact that other constitutional provisions equally obligatory (*Evans* v. *Gore, supra*) require that every tax on *property*, as distinguished from *income* derived from property, must be apportioned.

A.

As stated by this court in *Eisner* v. *Macomber*, it is, in construing the Sixteenth Amendment, "essential to distinguish between what is and what is not 'income', as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form". Constitutional provisions relating to the ordinary affairs of life necessarily must speak the current language as then commonly understood; otherwise they "would probably never be understood by the public" (*McCulloch* v. *Maryland*, 4 Wheat. 316, 407); and where, as in the Sixteenth Amendment, the provision plainly concerns the every day activities of men, it must be manifest that its purport and effect were intended to be readily solvable by the ordinary understanding of those to whom it was addressed. There is nothing to indicate that the members of the Congress that proposed the Amendment to the States or the state legislatures that ratified it understood the term "incomes" in any other than its commonly understood and judicially defined meaning. Indeed, while with respect to stock dividends, as is pointed out in the dissenting opinions of Mr. Justice Holmes and of Mr. Justice Brandeis in *Eisner* v.

Macomber (252 U. S. 220, 234, Mr. Justice Day concurring in the former and Mr. Justice Clarke in the latter), the law was by no means well settled in all the States that such dividends were capital and not income, with respect to increment of value realized upon the sale of property held for investment there was complete unanimity in holding that it was essentially capital and not income.

These considerations enable us immediately to lay to one side the suggestion, heretofore made by some judges and earnestly urged by the Government, that the term "income" embraces "everything that comes in" (see, *e. g., United States* v. *Oregon-Washington R. & Nav. Co.*, 251 Fed. 211, 212-3, 214; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 335), and the further suggestion that in the science of political economy or theoretical accounting the word has a peculiar, artificial, or technical meaning. *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414; *Lynch* v. *Turrish*, 247 U. S. 221, 227, 228. The former suggestion rests upon the bare etymological derivation of the word—an element which controls and influences common usage very slightly; and the latter yields to distinctions and doctrines of economists all but unknown to the ordinary individual, and which this court has declared are "such refinements [as] can hardly be deemed to have entered into the legislative purpose" (*Stratton's Independence* v. *Howbert*, *supra*). Manifestly, no substantial aid is to be derived from such lines of inquiry.

Prior to the adoption of the Amendment the meaning of the word income had been judicially defined by this court in *Gray* v. *Darlington*, by the highest courts of many of the States in the law of estates and trusts, and by the courts of Great Britain and of the British Dominions and Colonies in construing their Income Tax laws, as

excluding increment of value realized upon the sale of property held for investment. Probably no source is more enlightening than the decisions of the courts construing the term in question, for "it is a well-settled rule of construction that language used in a statute [or constitution] which has a settled and well-known meaning, sanctioned by judicial decision, is presumed to be used in that sense by the legislative body." *Kepner* v. *United States,* 195 U. S. 100, 124; *Norfolk Southern R.R. Co.* v. *Chapman,* 244 U. S. 276, 280-1.

B.

In *Gray* v. *Darlington,* 15 Wall. 63, decided in 1872, the question arose under the Income Tax Law of 1867, which levied a tax "upon the gains, profits, and income of every person . . . whether derived from any kind of property . . . or from any other source whatever." It appeared there that the plaintiff had in 1865 acquired some United States bonds in exchange for United States Treasury notes as an investment, and not in the course of any business, and that he had disposed of them in 1869 at an advance of $20,000 over the original cost of the notes. The Government attempted to tax this sum under the Income Tax Law of 1867 as "gains, profits and income"; but this court overruled its contention, and Mr. Justice Field speaking for the court used the following language (pp. 65, 66):

> "The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. The answer which should be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no just sense, be con-

> sidered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. . . .
>
> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. *Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.*"

It will be noted that the court was then speaking of an advance in value which had been actually realized by sale within the taxable year. To the same effect as *Gray* v. *Darlington,* was the opinion of Mr. Justice Grier rendered in 1865, *Bennet* v. *Baker* (footnote to 15 Wall. 67), and the judgment of the Circuit Court in *Chicago, B. & Q. R. R. Co.* v. *Page,* 1 Biss. 461, 466, decided in 1864. And, as shown above at pp. 8-9, in *Lynch* v. *Turrish,* 247 U. S. 221, decided in June, 1918, this court followed and approved the ruling in *Gray* v. *Darlington.*

It must reasonably be presumed that Congress, when it proposed the Sixteenth Amendment, and the state legislatures, when they ratified it, intended to adopt this judicial interpretation and definition of the word income.

The conclusion is, therefore, fully warranted that both those who proposed the Sixteenth Amendment and those who ratified it understood and appreciated the force and effect of the decision of this court in *Gray* v. *Darlington,* and acted upon the belief that such a deliberate and authoritative definition of "income" and "capital" for purposes of taxation would constitute at once the measure and the limitation of the extension of the power of Congress "to lay and collect taxes on incomes . . . without apportionment," so as not to conflict with

the constitutional provisions requiring direct taxes on property to be apportioned.

C.

Particularly must it be apparent that this was the understanding of the state legislatures, since they knew that it was universally held to be the law in the United States that a gain realized by a trustee upon the sale of a part of the *corpus* or principal of a trust fund constituted capital or principal and not income, and belonged to the remainderman and not to the life-tenant, when the life-tenant was, by the express terms of the instrument creating the trust, entitled to all "income" arising from the trust estate. *Mercer* v. *Buchanan,* 132 Fed. 501, 508, 137 Fed. 1019; *Graham's Estate,* 198 Pa. St. 216; *Neel's Estate (No. 2)*, 207 Pa. St. 446; *Matter of Gerry,* 103 N. Y. 445, 450; *Thayer* v. *Burr,* 201 N. Y. 155, 157-8; *Boardman* v. *Mansfield,* 79 Conn. 634; *Carpenter* v. *Perkins,* 83 Conn. 11, 20; *Outcault* v. *Appleby,* 36 N. J. Eq. 73, 78; *Parker* v. *Johnson,* 37 N. J. Eq. 366, 368; *Guthrie's Trustee* v. *Akers,* 157 Ky. 649, 651; *Slocum* v. *Ames,* 19 R. I. 401; *Smith* v. *Hooper,* 95 Md. 16; *In re Armitage* (1893), 3 Ch. 337, 346; 28 Eng. & Am. Encyc. of L. & P. (2nd ed.) p. 917; 39 Cyc. 444; 40 *id.* 1788. The rule upon the subject is accurately stated by Prof. Irvine in his article on "Trusts" in the Cyclopedia of Law and Procedure, as follows (vol. 39, p. 444):

> "As instruments creating trusts frequently provide for the payment of income to one set of beneficiaries, and the *corpus* to another set, it often becomes necessary to decide what is included within the term 'capital,' and what within 'income.' In general, the capital or *corpus* of the trust estate includes not only the property which originally comes into the trustee's hands, but its

> increase in value and whatever subsequently takes its place and represents it; hence it includes the money, including the profits, derived from a sale of stock, bonds, or other property of the trust estate, a common illustration of this being where the trustee, in order to protect the estate, buys in property at a foreclosure or other judicial sale and subsequently resells it at a profit."

Parker v. *Johnson*, 37 N. J. Eq. 366, 368, was a case precisely like the one which Prof. Irvine designated as "a common illustration" of the rule, and the Chancellor there said, referring to a profit realized upon the sale of a portion of the principal of a trust estate, that—

> "The profit [thus made] is not income. It was made by the trustee in the process of converting the investment, and, like a premium realized on the sale of government bonds in which the funds might be invested, it belongs to the fund."

The clear distinction between income and capital made and observed in cases affecting the rights of life-tenants and remaindermen was, it is proper to assume, familiar to most legislators. A large part of the invested capital of every community is held in trust subject to legal and equitable life estates with remainders over. Plainly, therefore, it is reasonable to assume that those who ratified the Amendment understood the word "incomes" in the light of its settled meaning in one of the commonest of legal relations.

That this common and familiar distinction did not directly appertain to taxation, is quite immaterial. Indeed, this court has so held. The learned district judge in *Towne* v. *Eisner*, 242 Fed. 702, 704 *et seq.*, attempted to distinguish the rule laid down in *Gibbons* v. *Mahon*, 136 U. S. 549, in respect of life-tenant and remainderman, by refusing to give it force and effect in cases involving income taxation. But this court reversed the

holding of the district judge upon this precise point, and treated as decisive the rule that the stock dividend there in question constituted capital and not income as between life-tenant and remainderman, saying in its opinion by Mr. Justice Holmes (245 U. S. at p. 426):

> "Notwithstanding the thoughtful discussion that the case received below we cannot doubt that the dividend was capital as well for the purposes of the Income Tax Law as for distribution between tenant for life and remainderman."

No other result would be in accordance with logic. And this will at once be apparent if we assume, for the moment, that an increase realized by the sale of a part of the *corpus* of a trust estate, is taxable as income. Under the settled rule of law, that increase would become part of the capital of the trust and ultimately belong to the remainderman and not the life-tenant.

There is in this supposititious case no difficulty in understanding that such an increase is essentially capital and remains capital when transmuted by sale into money, and the case of the *Merchants Loan & Trust Company as Trustee of Ryerson*, No. 608, now under advisement presents that very question. When the trust relation disassociates income from capital and places the enjoyment of each in a separate individual, it is easy to perceive that growth of capital assets is not under such circumstances income, even when the process of investment and reinvestment at some period of time operates to convert the principal into cash for reinvestment. But, manifestly, what is capital and what is income, as between the life-tenant and remainderman in the case supposed, is not altered in its essential character and nature and turned from one class into another merely because both the remainder and the life estate

happen to be vested in the same individual at the same time, which is the case where property is owned outright by an individual as in the case at bar or by a corporation as in the *Eldorado* case, No. 609. Logically, there is in either of such cases no more justification for requiring income taxes to be paid out of capital, than there would be for depriving a life-tenant of a part of his income in order to pay for a benefit derived by the remainderman, or in depriving the latter of part of his capital to pay an alleged *income* tax, when he is the recipient of no income whatever.

D.

For many years prior to the adoption of the Sixteenth Amendment, the British courts had held and have since continued to hold that capital in any form, whether the realized increment of value upon the sale of property by an individual or of capital assets by a corporation, is not taxable as income under the British income tax laws which have been in force since 1842. This British authority is peculiarly important in view of the well-known fact that American income tax legislation came to us from England and has always been in large part patterned after the English enactments (Black on Income Taxes, 4th ed., sec. 30): and it should, therefore, reasonably be presumed that both the Sixteenth Amendment and the Income Tax Acts were framed in the light of the British precedents, and "that Congress, in adopting the language of the English act, had in mind the constructions given to these words by the English courts, and intended to incorporate them into the statute" (*Interstate Commerce Com.* v. *B. & O. R. R.*,

145 U. S. 263, 284). See also *Interstate Commerce Com. v. Del., L. & W. R. R.*, 220 U. S. 235, 253-4; *McDonald v. Hovey*, 110 U. S. 619, 628.

Both in 1909, when the Sixteenth Amendment was proposed by Congress to the several States, and in 1913, when it was finally ratified, it was the settled law in Great Britain that the growth or increment in value of investments, or of the capital assets of a corporation, when realized by sale or other disposition (as distinguished from profits so realized where such sale is the taxpayer's trade or business) was principal or capital and not income within the scope of the income taxing laws of Great Britain and the British Dominions. *Assets Co., Ltd. v. Forbes* (1897—Court of Exchequer, Scotland), 3 Tax Cases 542, 548; 24 Rettie 578, 586; *Scoble v. Secretary of State for India* (1903—House of Lords) [1903] A. C. 299, affirming [1903] 1 K. B. 494; *Californian Copper Syndicate, Ltd. v. Harris* (1904—Exchequer, Scotland), 5 Tax Cases 159, 165-6, 167; *Taxation Commissioners v. Mooney* (1907—Privy Council), [1907] A. C. 342, 350; *Hudson's Bay Co., Ltd. v. Stevens* (1909—Court of Appeal), 5 Tax Cases 424, 436, 437, 440; *Tebrau (Johore) Rubber Syndicate, Ltd. v. Farmer* (1910—Exchequer, Scotland), 5 Tax Cases 658, 664-5; *Commissioner of Taxes v. Melbourne Trust, Ltd.* (1914—Privy Council), [1914] A. C. 1001, 1010.

In *Assets Co., Ltd. v. Forbes, supra*, decided in 1897, Lord Young said:

> "I wish to give expression to the doubt which I entertain, and which I understand is shared by Lord Trayner very strongly, as to the cases in which we hold that a gain made by the sale of property at a price more than was paid for it may be regarded as income. . . . I should say that I have really no doubt that any person, or any com-

pany making a trade of purchasing and selling investments, will be liable in Income Tax upon any profit which is made by that trade. . . . But it is another proposition altogether that, where that is not a trade, a gain or loss upon the purchase and re-sale of property comes within the meaning of the Income Tax Acts. Take even proper traders; if proper traders sell their old premises and buy new ones, and sell the old premises at a higher price than they paid for them, investing in the purchase of the site and the erection of new premises the price which they got, I should say it was a totally untenable proposition that anything in excess of what they had paid for the old premises, perhaps 20 years before, and which they got at a better time, that any excess upon the price which they paid at the better time is income within the meaning of the Act. I do not think it is at all. It is no more so in the case of a trader's income than in the case of a private individual selling his house at more than he had paid for it, or selling his carriage or pictures at more than he had paid for them. That is not income in any sense; while a dealer in pictures, like a dealer in goods or a dealer in the buying and selling of houses, who made it a trade, would then come within the region of Income Tax."

In the case of *Californian Copper Syndicate, Ltd.* v. *Harris, supra*, decided in 1904, Lord Justice Clerk stated the rule as follows:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit in the sense of Schedule D of the Income Tax Act of 1842 assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business."

And Lord Trayner concurring declared that the case then before the court was not "the case of a company selling part of its property for a higher price than it had paid for it, and keeping that price as part of its capital, nor a case of a company merely changing the investment of its capital to pecuniary advantage" (5 Tax Cases at p. 167).

In *Taxation Commissioners v. Mooney, supra*, decided by the Privy Council in 1907, it appeared that the taxpayer had realized a profit on the sale of a mine in which he had invested, and it was held that this profit was not subject to taxation, Lord Macnaghten saying that the Privy Councillors agreed with the court below that—

> "A change in the form of property by a person who does not traffic in that kind of property cannot be regarded as producing income taxable under the Income Tax Acts."

The case of *Hudson's Bay Co., Ltd. v. Stevens, supra*, decided in the Court of Appeal in 1909, again presented the question in an important case involving a very large amount of tax; but the court adhered to the settled principle, Lord Justice Farwell saying:

> "It is well settled that income, not capital, is taxable under the Income Tax Acts. . . . It is clear, therefore, that a man who sells his land, or pictures, or jewels, is not chargeable with income tax on the purchase-money or on the difference between the amount that he gave and the amount that he received for them. But if instead of dealing with his property as owner he embarks on a trade, then he becomes liable to pay, not on the excess of sale prices over purchase prices, but on the annual profits or gains arising from such trade, in ascertaining which those prices will no doubt come into consideration."

And in *Tebrau (Johore) Rubber Syndicate, Ltd. v. Farmer, supra*, decided the following year (1910) in the Court of Exchequer of Scotland, where a rubber company

sold out all its property at a profit, Lord Salvesen spoke as follows:

> "I am unable to distinguish the position of the Appellants from that of a person who acquires a property by way of investment and who realises it afterwards at a profit. It is well settled that in such a case the profit is not part of the person's annual income liable to be assessed for income tax but results from an appreciation of his capital. No doubt if it is part of his business to deal in land or investments, any profits which in the course of that business he realises form part of his income; but the mere fact that a person or company has invested funds in the purchase of an estate which has subsequently appreciated and so has realised a profit on his purchase does not make that profit liable to assessment. Here the Appellant Company was formed primarily to acquire and develop a certain estate mentioned in the Memorandum and any other estates suitable for the cultivation of rubber; and to carry on the business of developing and cultivating the said estates.
>
> "No doubt power was also taken to sell any part of the undertaking and property of the Company; and I assume that the promoters of the Syndicate had in view from the first that it might become expedient to do so; but I am unable to infer from this fact, taken along with the ultimate sale of the entire assets to a new company, that it was part of the trade of the Syndicate to purchase and sell lands.
>
> "The fallacy of the view taken by the Commissioners is further apparent from the fact that the profit which ultimately results from an appreciation of value is not necessarily referable to the particular year in which it is realised.
>
> "In the case before us it is no doubt true that the Syndicate only existed a little more than a year; but that does not in the least affect the question whether the profits were made by way of annual income or resulted from appreciation of capital. Suppose the Company had been in existence for ten years before it sold its whole property at

a profit, how could it be said that the profit so made was income of the last year in which it existed?"

The striking resemblance between the reasoning of this opinion and that contained in the opinion of this court in *Gray* v. *Darlington*, 15 Wall. 63, will at once be perceived; and like *Gray* v. *Darlington*, the British authorities make it quite clear that the advance in the value of an investment realized otherwise than in the course of trade or business, "is not income at all, but merely increase of capital and not subject to a tax as income."

The rule to this effect, thus settled in England and Scotland, also prevails in the British Colonies and Dominions. As to Canada, see Pontifex's Canadian Income Tax, p. 23, and Breadner (Commissioner of Taxation) on The Business Profits War Tax Act and The Income War Tax Act, p. 18; as to Australia, see Bedwell's Australasian Judicial Dictionary (1920), p. 76; *Mooney* v. *Commissioners of Taxation* (1905), 3 Commonwealth Law Rep. 221, 228-9 (Griffith, C. J.), affirmed [1907] A. C. 342; *Webb* v. *Australian Deposit & Mortgage B'k, Ltd.* (1910), 11 *id.* 223, 227 (Griffith, C. J.); *Bohemians Club* v. *Acting Federal Commissioner of Taxation* (1918), 24 *id.* 334; *McLachlan* v. *Commissioner of Taxes*, [1912] South Australian Law Rep. 138 (Way, C.J.); *Shiels (Public Officer for the Bank of Adelaide)* v. *Commissioner of Taxes* [1912] *id.* 175; and as to South Africa, see Barnes' Income Tax Practice in South Africa (1919), pp. 137-40; *Commissioner of Taxes* v. *Booysen's Estate, Ltd.*, South African Law Rep. [1918] App. Div. 576.

The following extract from Bedwell's work, above referred to, accurately states the law upon the point as held, not only in Australia, to which this book particularly

refers, but in all the British Colonies and Dominions as well (p. 76):

> "The term 'income' as used in N. S. W. Land and Income Tax Assessment Act, 1898, includes 'profits, gains, rent, interests, salaries, wages, allowances, premiums, stipends, charges and annuities' (sect. 68). The proceeds of property sold are *primâ facie* capital and not income, and the term 'profits' does not include the difference between the cost price of property and the price at which it is afterwards sold, unless the buying and selling of such property is the ordinary business of the person alleged to be a taxpayer. Per Griffith, C. J.: *Mooney* v. *Commissioners of Taxation* (1905), 3 C. L. R. at pp. 228-229 . . . affirmed, [1907] A. C. 342 . . . followed, *Bohemians Club* v. *Acting Federal Commissioner of Taxation* (1918), 24 C. L. R. 334; *McLachlan* v. *Commissioner of Taxes, Rymill* (*Public Officer for Canowie Pastoral Co., Ltd.*) v. *Commissioner of Taxes* [1912] S. A. L. R. 138," [citing p. 77 also,] Griffith, C. J. in *Webb* v. *Australian Deposit & Mortgage Bank, Ltd.* (1910), 11 C. L. R. at p. 227, and *Shiels* (*Public Officer for the Bank of Adelaide*) v. *Commissioner of Taxes,* [1912] S. A. L. R. 175.

It is equally well settled by the decisions of the British courts that under their income tax laws capital losses are not deductible. *Smith* v. *Westinghouse Brake Co.,* 2 Tax Cas. 357 (1888); *Inland Revenue* v. *Western Steamship Co.,* 44 Sc. L. R. 715 (1907); *Royal Insurance Co.* v. *Watson,* 3 Tax Cas. 500; *Stott* v. *Hoddinott,* 7 Tax Cas. 85; *Watney* v. *Musgrave,* 1 Tax Cas. 272.

E.

Prior, therefore, to 1909 when the Sixteenth Amendment was proposed and 1913 when it was finally adopted, the word "income" was generally understood and had been quite generally defined as having a meaning distinct

from, and exclusive of, the increment of value realized upon the sale of property held for investment, by an individual, or the capital assets of a corporation. "In the construction of the language of the Constitution . . . we are to place ourselves as nearly as possible in the condition of the men who framed that instrument" (*Ex parte Bain*, 121 U. S. 1, 12) and "that which it meant when adopted it means now" (*South Carolina* v. *United States*, 199 U. S. 437, 448). So regarded, it is submitted that the terms of the Sixteenth Amendment could not in the period from 1909 to 1913 have been understood by Congress or the state legislatures as including within the power to tax "incomes" without apportionment, the power so to tax the growth or increment of value constituting capital accretions realized as a result of a change in investments made otherwise than in the course of the conduct of a trade or business. Certainly, it was not intended to authorize or permit the taxation of capital under the guise of taxing income.

If the views expressed by this court subsequent to 1913 be analyzed, this conclusion is strongly reinforced. The tax laid upon corporations by the Corporation Excise Tax Act of August 5, 1909, (36 Stat. 11, 112, c. 6, sec. 38) was, as shown above, an excise imposed upon the privilege of doing business in corporate form, and it was measured by income to the extent and in the special sense defined in the statute itself. The so-called "income" which measured this tax was not and was not intended to be the "income" signified and intended in and by the Sixteenth Amendment, and it has been repeatedly recognized by this court that the senses in which the terms were used are different in the two cases. The court declared in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414, 416, that—

"As has been repeatedly remarked, the Corporation Tax Act of 1909 was not intended to be and is not in any proper sense an income tax law."

See also *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 150, 165; *United States* v. *Whitridge*, 231 U. S. 144, 147, 149; *Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69, 72; *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 183; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 193, and *United States* v. *Cleveland C. C. & St. L. Ry. Co.*, 247 U. S. 195.

Where, on the other hand, a true income tax act was involved and capital profits were realized upon the change of an investment under circumstances in no wise related to the carrying on of business, as in *Gray* v. *Darlington*, 15 Wall. 63; or where under a true income tax law capital profits were realized, not in the course of the business, but upon the winding-up and termination thereof, which is after all but another mode or form of changing an investment, as was the case in *Lynch* v. *Turrish*, 247 U. S. 221, the court in each instance refused to consider such an increment of value when realized by sale or conversion as any part of taxable income, and declared that it remained capital, despite its conversion or transmutation into cash. And this court has recently stated that "enrichment through increase in value of capital investment is not income in any proper meaning of the term" (*Eisner* v. *Macomber*, 252 U. S. at pp. 214-5).

F.

An increase or increment in the value of an investment, not made or held as a part of any trade or business transaction, is plainly "a gain *accruing to* capital" and a "*growth or increment* of value *in* the investment,"

within the definition of the court in *Eisner* v. *Macomber, supra.* In no proper sense does it *proceed from* the property, as do rents, interest, dividends and other familiar forms of income; and such a gain, when realized, cannot properly be described as "*severed from* the capital" for it remains an integral part of the capital as much as if it had not been converted.

Before conversion into money, no one would question that the property, so held as an investment merely, was capital, although it then included the enhancement of value, and that it was not taxable except by the rule of apportionment. Bearing in mind that the Sixteenth Amendment is not to be "extended by loose construction" and that it is "essential to distinguish between what is and what is not 'income' . . . according to truth and substance, without regard to form" (*Eisner* v. *Macomber,* 252 U. S. at p. 206), we must find some distinct benefit to the taxpayer as *income* directly attributable to the conversion, before it can be declared that what the taxpayer now has is, not merely his capital, but income instead. Otherwise, the mere fact of conversion, that is, the form alone, would prevail over the substance and be made the decisive factor. Yet the court has declared, although in considering the Act of 1909, that "*subsequent change of form by conversion into money did not change the essence*" (*Doyle* v. *Mitchell Brothers Co.,* 247 U. S. at p. 187). Let us suppose the situation of an investor who desired to change his investments and to accomplish that result either by sale and new purchase or by exchange. In each instance, his efforts to change his capital from one form of investment and transfer it to another—not as a matter of business or trade, but solely as a change in the form of his investments—would

result in a loss of capital, exacted under the guise of an income tax, and would constitute a plain penalty upon capital imposed simply because of a change in the form of the taxpayer's capital investments.

Mere conversion of capital investments and change into money cannot, therefore, be determinative, even though more money is thus actually brought to hand than was originally put into the investment several years before. Otherwise, *Lynch* v. *Turrish,* 247 U. S. 221, was wrongly decided. There the taxpayer withdrew, upon the dissolution of his company, more money than he had put in, but only as much as his interest in the property in which he had his investment was then actually worth. All this was held to be capital and not income, despite the fact that it was received in money and was the outcome of a conversion.

It is true that it was stated in the opinion of the court in *Eisner* v. *Macomber,* 252 U. S. at p. 212, that—

> "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment."

This was plainly an *obiter dictum,* and was probably the result of concessions made in the briefs of counsel upon the original hearing and the application for a rehearing as well as upon the rehearing. The proposition advanced in argument that realized capital profits were income was not involved in the case, was not disputed, and, being irrelevant, was not disputable. It was advanced by the taxpayer's counsel and, naturally, as it was for the advantage of the revenue was not disputed by the Government. Unless limited to sales of such stock in the course of

business transactions, this statement was inconsistent with *Gray* v. *Darlington*, 15 Wall. 63, *Gibbons* v. *Mahon*, 136 U. S. 549, and *Lynch* v. *Turrish*, 247 U. S. 221, and with the decisions of the state courts and of the courts of Great Britain and the British Dominions cited above, as well as with the reasoning in *Eisner* v. *Macomber* itself. The inconsistency will be immediately apparent if we assume that Mrs. Macomber had received the dividend stock in question as a trustee. Such stock would then, of course, have constituted a part of the principal of the trust fund and belonged as such to the remainderman and not to the life-tenant (*Gibbons* v. *Mahon, supra*); and it would still have constituted part of the *corpus* or capital if thereafter turned into cash, and the life-tenant would, in that event, still be entitled to no participation whatever in any of the proceeds of the sale. Nevertheless, according to the *dictum* quoted above, an income tax would have been payable in respect of this conversion of capital assets and change in the form of the investment of the trust estate. But, manifestly, the remainderman, who is not entitled to any income and only to capital, ought not to be required to pay a tax upon "income"; and, equally plainly, the life-tenant, who is entitled to the whole income but has not received any part of this converted stock dividend because, as to him, it constitutes capital, should not be called upon to pay a tax upon gains accruing to and received by another. This evident anomaly indicates the fallacy inherent in the passage quoted from the opinion in *Eisner* v. *Macomber*.

The foregoing views have recently found acceptance and approval in the case of *Brewster* v. *Walsh*, decided on December 16, 1920, by District Judge Thomas of Connecticut, 268 Fed. 207, now before this court for review *sub nom. Walsh* v. *Brewster*, No. 742.

It, therefore, follows that the word "income" had a well-established, clearly defined and unambiguous meaning at the time of the consideration and adoption of the Sixteenth Amendment, that this meaning excluded realized increase or increment of value on the sale of capital investments, that the Sixteenth Amendment does not authorize a tax upon capital growth, increment, or accretion realized on conversion of a permanent investment, and that if the Income Tax Law of 1916 can be construed as imposing such a tax, it is in that respect unconstitutional and void.

III.

THE INCOME TAX LAW OF 1916 DOES NOT LEVY A TAX UPON THE GROWTH OF INCREMENT IN VALUE OF CAPITAL ASSETS WHEN REALIZED BY SALE.

A.

The Act of 1913 did not tax increase in value of capital investments.

The framers of the original Income Tax Law of October 3, 1913 (c. 16, 38 Stat. 166) understood perfectly well the rule declared in the case of *Gray* v. *Darlington* by this court and the English cases cited and discussed above. Indeed, reference to the debates in Congress will show not only a clear understanding that increment in value of property held for investment was not in its nature income, but that it was not the intention of Congress in the Act of 1913 to tax realized increment of capital investments.

Thus, on April 26, 1913, the Income Tax Bill (H. R. 3321) was before the House of Representatives as Committee of the whole House on the state of the Union. (Congressional Record April 26, 1913.) Mr. Hull (the

draftsman of the income tax provisions) was explaining the bill in detail, and with reference to the Sixteenth Amendment, when the following occurred (Cong. Rec. vol. 50, part 1, at p. 513):

> "*Mr. Hull.* I will say to the gentleman frankly that it has been held in construing all these laws that I have observed, that unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital . . .
>
> *Mr. Mann.* What I really wanted to get at was not that, but whether it would relate back so as to cover all profit. Suppose a man bought property many years ago which probably last year was worth as much as it is this year. He sells it this year. What are his profits? How does he arrive at what his profits are?
>
> *Mr. Hull.* My judgment would be that as to an occasional purchase of real estate by one not a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land is purchased and sold during the same year.
>
> *Mr. Mann.* I hope that statement will remain in the *Record.*"

And at page 506 we find:

> "*Mr. Hull.* The rulings of the Treasury Department and the decisions of the courts of this country with respect to similar provisions of the old income tax laws and also the English rules of construction, all essential portions of which will be embraced in the Treasury regulations, will make clear the distinction between taxable profits or income on the one hand and capital or principal on the other."

So far as appears this view as to the Act of 1913 was not modified by Congress in connection with the Act of 1916. On the contrary, in the debate in the Senate on August 30, 1916 (53 Cong. Rec., part 13, p. 13407, *et seq.*) the question of taxing increase in value of capital investments was debated and the holding of this court in *Gray v. Darlington* read. Thereupon Senator Hitchcock said:

"I still am not able to understand it. I will put a case to the Senator. Suppose a man has purchased in a certain year stocks or bonds and two years thereafter there is an advance of $20,000. Is the man just taxed for one year only on the profit made?

"Mr. Clarke of Arkansas: He is not taxed at all on that because it ceases to be income and becomes capital."

The entire debate is quoted in the appendix, and whilst it is somewhat confusing, it is not improbable that the view of Senator Clarke, that an advance in value of stocks or bonds was capital, was acquiesced in by Senate and House.

At any rate, the ruling of this court in *Gray* v. *Darlington* was clearly brought to the attention of the Senate in August, 1916, and nevertheless the language adopted was substantially the same as that used in the Acts of 1867 and 1913. Surely, if it had been the intention then to tax increase in value of capital investments, clear and unambiguous language would have been used, in order to overcome "a presumption, resistless except against an intention imperatively clear" (Mr. Justice McKenna in *Lynch* v. *Turrish*, 247 U. S. at p. 230).

In neither the Act of 1913, nor the Act of 1916 was the growth or increment or increase of value of property held for investment expressly made income and taxed as such. As Mr. Hull stated in 1913, the rule of statutory construction, which he correctly gathered from the decisions discussed under point II, *supra*, was that "unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital." Hence, if we had no constitutional provision commanding that essentially direct taxes (such as a tax on the

proceeds of the sale of property or the substitute therefor) should be apportioned, the rule of construction would reasonably be that no part of the proceeds of the sale of property held for investment and not in connection with the carrying on of a business or trade would be taxable as income unless expressly made so. However, logically a statute could not make that income which was not so in its very nature except as fixing a standard by which to measure a tax. If the original asset as capital could not be taxed except by the rule of apportionment, then manifestly it should logically follow that the proceeds of or substitutes for such capital assets were not taxable except by apportionment.

But however this may be, there can be no doubt that according to many authorities the increment or accretion in value of capital assets when realized had generally not been treated as coming within the term "income" unless expressly made so by the taxing statute, assuming *arguendo* only that Congress could, as the British Parliament could, make that income for the purposes of an income tax law which was not in truth and substance income at all. The statute before the court does not purport to make such increment or accretion income; it is very doubtful whether Congress intended to treat it as such, and it should not now be made so by administrative or judicial interpretation. So far as appears, Congress had no such specific intent and may have contemplated and intended quite the contrary.

The principles which should govern this point are succinctly stated by Mr. Justice McReynolds in the case of *Gould* v. *Gould*, 245 U. S. 151, 153, speaking for the unanimous court, in the following language:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their pro-

> visions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. *United States* v. *Wigglesworth*, 2 Story 369; *American Net & Twine Co.* v. *Worthington*, 141 U. S. 468, 474; *Benziger* v. *United States*, 192 U. S. 38, 55.
>
> ". . . The use of the word itself in the definition of 'income' causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed."

If the court was thus unable to assert that annual payments of alimony received by a divorced wife fell fairly within the terms of the Income Tax Law of 1913, it must *a fortiori* be unable to assert that the realized increment or accretion of value of property held for investment falls fairly within any of the terms employed in that act or in the act of 1916, which in this respect is substantially the same.

The grave doubts which reasonably exist both as to the intent of Congress, as well as to the constitutional power to tax such increment at all except by apportionment, should be resolved in favor of the taxpayer. The Congress well knew, for it had been repeatedly admonished by this court, that it was bound to express its intention to tax increment of value of property held for investment in clear and unambiguous language. Thus, in *Eidman* v. *Martinez*, 184 U. S. 578, 583, Mr. Justice Brown speaking for the court said:

> "It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of exception confining the

operation of duty. *Warrington* v. *Furbor*, 8 East, 242, 247; *Williams* v. *Sangar*, 10 East, 66, 69; *Denn* v. *Diamond*, 4 B. & C. 243, 245; *Tomkins* v. *Ashby*, 6 B. & C. 541; *Doe* v. *Snaith*, 8 Bing. 146, 152; *Wroughton* v. *Turtle*, 11 M. & W. 561, 567; *Gurr* v. *Scudds*, 11 Exch. 190, though the rule regarding *exemptions* from general laws may be different. *Cooley on Taxation*, 146; *In Matter of Enston*, 113 N. Y. 174, 177."

B.

The changes in phraseology in the Act of 1916 do not indicate any intent so to broaden the scope of the income tax as to include realized increment as an item of taxable income.

In the appendix the corresponding relevant portions of the Acts of 1913 and 1916 are printed in parallel columns, with appropriate variations in type to denote new matter added and old matter omitted or modified. From an inspection and comparison of the two acts, it will appear that the change which has a direct bearing upon the topic now under discussion was that in the Act of 1916 the phrase "entire net income received in the preceding calendar year from all sources" is used in place of the phrase in the Act of 1913, "entire net income arising or accruing from all sources in the preceding calendar year."

"Received," however, is a word of narrower, not broader, scope than "arising or accruing." Income which is earned or due may be said to "arise" or "accrue" and hence be within the Act of 1913, but the same income would not be within the Act of 1916 unless in fact received within the year by the taxpayer. Familiar instances are interest on real estate mortgages due late in

the calendar year but not actually paid until the following year, and interest on corporate bonds or other obligations not paid when accrued but subsequently collected. Instances could be multiplied, but those suggested are sufficiently typical, and in themselves afford an adequate explanation for the change in verbiage. Whilst there is, of course, a shade of difference, the substance is the same so far as the present question is concerned. *Lynch* v. *Turrish*, 247 U. S. at p. 230, and *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 345.

In the Act of 1916 a new subdivision (sec. 2 subd. (c), is added as follows:

> "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

This subdivision, however, is limited by section 1 and the preceding subdivision (a) of section 2. By the former the tax is imposed on "net income," by the latter net income is specified and defined *in precisely the same words as in the Act of 1913.* Subdivision (c) must, therefore, be construed as applicable only to such gains derived from sales or dealings in property as are taxed. Subdivision (c) does not impose any tax, but merely states the basis of determining or computing the tax already imposed.

A new subdivision (Fifth) of section 5 is added allowing as an additional deduction—

> "In transactions entered into for profit but not connected with his (the taxpayer's) business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom."

Under the Act of 1913 there is no similar provision. *Mente* v. *Eisner*, 266 Fed. 161 (C. C. A. 2nd Cir; certiorari denied by this court October 11th, 1920, No. 447).

Far from this provision indicating any intent to tax realized increment, the only reasonable inference is directly to the contrary. The two acts plainly taxed as income gains derived from transactions entered into for profit, in the purchase and sale of real or personal property outside of the taxpayer's regular business, or otherwise entered into for profit, such as the usual speculations in securities on a stock exchange, produce exchange, board of trade, etc., or speculative purchases and sales of real estate as distinguished from investments. It is a matter of common knowledge that the great bulk of transactions on the exchanges are of this speculative nature, and they are entirely distinct from the purchase or acquisition of securities for permanent investment. Under the Act of 1913 losses were not deductible unless the taxpayer could establish that the nature of his transactions was such as to constitute "trade" and come within the term

> "losses actually sustained during the year incurred in trade."

Subdivision Fifth of section 5 was enacted to enable the taxpayer to deduct losses resulting from other "transactions entered into for profit but not connected with his business or trade." This clearly excluded transactions entered into for investment and not solely for profit.

It was, therefore, evidently the intent in the Act of 1916 to make the deductions allowed *pari passu* with the constituents of taxable income. The fact that losses outside of business were allowed only to this limited extent

is strongly indicative that capital profits realized on the sale of investments were not being taxed.

C.

The well settled meaning of the word "income" in common speech, as exclusive of realized increment, should be deemed to be the meaning of that word in the Act of 1916.

The intent of the act is plainly to tax the *annually* recurrent income of a taxpayer. The great mass of the people who invest their savings in real estate and in the purchase of investment securities productive of income certainly do not regard realized increase of value in such investments as "income". The realization of profit through sale is rarely the controlling motive in making such investments. They are not strictly entered into for profit but for investment. Safety and interest or dividends are the impelling factors. Under the Act of 1916 a loss sustained by the taxpayer on the sale of his home is not deductible. Is it not almost inconceivable that Congress would have taxed as income the profit realized by a householder or investor upon the sale of his home or of the securities representing his savings, without using language imperatively clear, when not permitting the deduction of losses in similar transactions?

The rule to be applied to the construction of the Acts of 1913 and 1916 is stated in *Black on Income Taxes*, 4th Ed., Sec. 30, p. 36, as follows:

> "It is another and ancient rule in the construction of statutes that the meaning of a doubtful word or phrase may be ascertained by reference to the meaning of other words or phrases with which it is associated, and that, where several things are referred to they are presumed to be of the same class when connected by a copulative conjunction

unless a contrary intent clearly appears. For example all the acts of Congress on the subject of income taxation, from 1862 to the present time, have associated together the words 'gains', 'profits' and 'income' as descriptive of the subject taxed, and the same is true of the income tax laws of some of the States. These words may be traced far back in the history of English taxation. The original income tax law of that country, enacted in 1799 imposed a tax on 'income' by that name, but the acts of 1842 and 1853 introduced the associated terms 'profits and gains' whence they were apparently borrowed by Congress in framing the Act of 1862 and have since persisted in use. Applying the rule above stated we are justified in asserting the following principles as applicable to the interpretation of the phrase in question. If it is doubtful whether or not a particular fund or acquisition is taxable as 'income' under the statute, it is not taxable unless it is income in the nature of 'gain' or 'profit'. If any item is clearly included in the description of 'gains' yet it is not taxable unless it is a gain in the nature of incomes or profits. And although the disputed item may be certainly a profit in one sense of the word, yet it is not taxable unless it be a profit accruing by way of gain or income."

D.

The provisions of the Act of 1916 with regard to deductions are inconsistent with the inclusion of realized increment as an item of taxable income.

Broadly speaking the deductions allowed are all such as relate to true income and not such as relate to isolated transactions and instances of the realization of increment of value on investments.

Under section 5 of the Act of 1916, the "Deductions Allowed" include (see appendix for quotation in full) the following:

(1) Necessary expenses *of the business or trade;* (2) interest; (3) taxes; (4) "losses actually sustained during the year incurred in his business or trade" . . . (5) losses to an amount not exceeding the profit in "transactions entered into for profit"; (6) worthless debts; (7) "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade", and (8) a special provision for oil and gas wells.

Then follow a prohibition of allowance of deductions, namely,

> "No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments,"

and a further prohibition of the deduction of the expense of restoring property for which an allowance was or had been made.

It is further to be noted that in the usual case of the sale of a taxpayer's home, or other real property, freehold or leasehold, held for investment, which is not used in his business or trade, there is no deduction allowed for exhaustion, wear and tear, and that no loss on the sale of a home, or of property acquired by gift or inheritance is deductible in fixing net income.

If it was intended to tax realized increment of value in investment property, there was a remarkable oversight in failing to provide for its taxation in the many instances where after the increment of value has accrued title to the property passed by gift, devise, bequest, or inheritance, and the property was then sold, without realization of further advance in value, by the donee, devisee, legatee, or heir. Obviously, by a mere gift of property

which had greatly increased in value the collection of any tax on the amount of such increase could be prevented.

E.

Full meaning and effect can be given to all the terms and provisions of the Act of 1916 through the construction advocated, namely, that realized increment of value was not included as an item of taxable income.

It is submitted that it has been decided by this court that the general expression "gains, profits and income from any source whatever", or its equivalent, contained in the acts of 1867 and 1913, did not include realized increase or increment of value of property held for investment, and that these general words could have ample scope if held to embrace only gains and profits properly and accurately within the current meaning of the term "income." So likewise as to the term "sales or dealings in property," it is submitted that its true intent and meaning is "*income* derived from sales or dealings in property", and does not include the conversion or transmutation into money or other property of a capital investment because the proceeds do not represent income. In other words, the controlling factor is not the sale or the dealing in property, for we are not discussing an excise tax, but *income* realized from such a transaction, that is to say, what is properly to be denominated income as distinguished from capital.

The words of the statute have an apt and appropriate function with respect to trade or business transactions and speculations, which will give adequate force and effect to the provision without necessarily including a gain

realized upon the increase in value of a capital investment. The distinction between the former and the latter is quite clear. Annual net profits of a business or trade are ascertained after deducting all the expenses and losses of the business from the gross aggregate of profits and other income, and this surplus alone constitutes the annual net income of such business or trade, regardless of the value of particular assets or of the profit or loss on particular transactions. But a gain derived from an isolated sale of an investment is in a totally different class and to be treated according to different rules. It is not part of the annual or other net income of a taxpayer in any proper or reasonable sense, but a profit resulting from an isolated and unusual transaction.

All the other terms of section 2 (a) of the act clearly relate to true income, and do not cover realized increment.

F.

The construction adopted and enforced by the Commissioner of Internal Revenue results in hardship, injustice and unreasonable discrimination among classes of taxpayers.

As examples of hardship and inequality attention may be called to the following instances:

(a) While in the case of a going business, or in transactions entered into for profit, losses are deductible, they are not deductible in other transactions, however much capital may thereby have become impaired.

(b) In the case of property held for a long period by an investor, or as an investment of trust funds by a fiduciary, losses are not deductible under the Act of 1916 be-

cause such transactions are not "entered into for profit." Hence, in the usual instance of losses incurred in one year on the sale of investments and profits realized in other years, or *vice versa,* the losses could not be deducted but the profits would be taxed and not allowed to be offset as against losses theretofore sustained.

(c) Under the progressively graded rates of tax, a tax upon the realization of the increment of value may be levied at a rate out of all proportion to the increment if apportioned *pro rata* during the period of accrual. This point has become of the greatest practical importance under the act of 1918. That it results in great hardship and injustice under the Act of 1917 is shown by the enormous tax exacted from the Ryerson Trust (No. 608) where the $700,000 profit conceded to have accrued over a period of four years and to belong to an undetermined number of beneficiaries, was taxed as a single income for one year without any deductions.

The sole theory upon which income taxes on increment of value are being levied is that such increment is not taxable as income until realized, and that, although it accrues from year to year during a series of years, it is not unjust that it should be taxed when actually realized by sale. This theory might work fairly if the increment were then apportioned over the period of accrual, retroactively, with appropriate provision for deductions of decrease in value of similar investments. This would be both fair and feasible. The act before the court, however, has no such provisions. The graded rates of super-tax make the tax, when the increment of value is realized, out of all proportion as compared with the rate during the period of accrual, so that, as in the *Ryerson* case, the tax was at least ten times higher than it would have been if apportioned to the years when it actually accrued

among the beneficiaries entitled to the capital profit realized.

The rule to be applied under such circumstances is stated by the court in *Knowlton* v. *Moore*, 178 U. S. 41, 77, as follows:

> "We are, therefore, bound to give heed to the rule, that where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. *Bate Refrigerating Co.* v. *Sulzeberger*, 157 U. S. 1, 37; *Wilson* v. *Rousseau*, 4 How. 646, 680; *Bloomer* v. *McQuewan*, 14 How. 539, 553; *Blake* v. *National Banks*, 23 Wall. 307, 320; *United States* v. *Kirby*, 7 Wall. 482, 486."

G.

The contention of the Government based on practical construction is not well founded.

A contention made by the Government in the *Ryerson Trustee* and *Eldorado* cases (Nos. 608 and 609) will doubtless be repeated in the case at bar, namely, that the Treasury Department in 1914-1915 ruled that realized increment was included under the Act of 1913 as an item of taxable income and assessed and collected income tax accordingly, and that this practical construction must be deemed to have been adopted by Congress by the enactment of the Act of 1916 in substantially the same language as the Act of 1913. This contention, however, is somewhat inconsistent with the Government's further position that by substituting the word "received" for the words "arising and accruing" the whole scope and meaning of the act were in this respect clearly changed.

In answer to the contention based on practical construction it is submitted that there is no authority in

support of this contention applicable to the present situation, namely, a ruling by a department of the Government in direct violation of a decision of this court upon the exact point of construction in question, rendered many years prior to the departmental ruling, and never questioned by the courts but followed by a decision of this court directly to the contrary of the departmental ruling. *Gray* v. *Darlington*, the authority of which has never been questioned, is directly the opposite of the departmental ruling on this point, and in 1918 this court in *Lynch* v. *Turrish*, construing the Act of 1913 with respect to which such ruling was made, held the ruling to be erroneous. Furthermore, the very point as to the adoption of a departmental construction by the subsequent reenactment of the law so construed was necessarily involved, though not passed upon by this court, in *Gray* v. *Darlington*. The first federal income tax law enacted by Congress was that of 1861 (12 Stat. 309). This law was re-enacted, with changes in rate, in 1862 (12 Stat. 473); a similar law with further changes in rate was enacted in 1864 (13 Stat. 223, 281) and amended in 1865 (13 Stat. 469-479), and in 1867 (14 Stat. 471, 477), sections 116 and 117 of the act of 1864 were amended in the form quoted above at page 7 of this brief. In the appendix, the relevant portions of each of these earlier acts are printed. On comparing their phraseology, it will be noted that the four acts in so far as relevant are substantially identical. The last one of the series, that of 1867, was construed in *Gray* v. *Darlington*, decided in 1872. At the time of its enactment the practical construction, of taxing realized increment as income, had been enforced for some five or six years. As early as May, 1863, the Commissioner of Internal Revenue had ruled as follows:

"No. 110. Gains or profits realized from the sale of property during the year 1862, which property was purchased before the excise law went into effect, shall be returned as income for the year 1862. . . .

"Losses incurred in the prosecution of the business are a fair offset to gains derived from business but not from those portions of income derived from fixed investments, such as bonds, mortgages, rents, and the like." (Rulings of Internal Revenue Department, 1871, Government Printing Office.)*

Yet this court in *Gray* v. *Darlington*, decided in 1872, ignored these definite and long established rulings of the Department.

That an erroneous construction by a department is in no way binding on the court was not only recognized in *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, 247 U. S. 221 and 330, but directly ruled in *Merritt* v. *Cameron*, 137 U. S. 542, 552; *United States* v. *Tanner*, 147 U. S. 661, 663; *Houghton* v. *Payne*, 194 U. S. 88; *Savings Bank* v. *United States*, 19 Wall. 227, and *Studebaker* v. *Perry*, 184 U. S. 258, 269. In the case last cited the court said:

"The doctrine invoked is a useful one but its application should be restricted to cases in which the construction involved is really one of doubt and where those to be affected have relied on the practical construction, *and rights have accrued by reason of such reliance.*"

* The rulings of the Department were published by the Office of Internal Revenue in 1871, Government Printing Office.

IV.

As the sale or conversion of the stock of the Goodrich Company represented an actual loss, no part of the proceeds was taxable as income of the taxpayer.

Assuming, *arguendo*, that increase in value of capital when realized by sale is taxable as income under the Sixteenth Amendment and the Act of 1916, it is nevertheless submitted that no part of the proceeds of the sale of the stock of the Goodrich Company was taxable because such sale resulted not in any gain but in an actual loss to the taxpayer.

The record in the case at bar conclusively establishes that the plaintiff did not receive or realize any gain or profit whatever from the sale of the shares of the capital stock of the Goodrich Company, but as matter of fact sustained a loss or diminution of capital value of $22,253, instead of a gain or profit of $120,700 (pp. 8, 9).

Section 2 of the Income Tax Law of 1916 provides that "the net income of a taxable person shall include gains, profits, *and income* derived from sales or dealings in property," etc. The addition of the word "income" to the words "gains, profits," however, added nothing, and never should have been employed, for it served no useful purpose. It would, of course, be absurd to define income as being income. Mr. Justice McReynolds pointed out in the case of *Gould* v. *Gould*, 245 U. S. 151, 153, with respect to the word "income" in the Act of October 3, 1913, 38 Stat. 144, 166, that "the use of the word itself in the definition of 'income' causes some obscurity."

There should be no difficulty in concluding that within long recognized canons of statutory construction the general word "income" following the enumeration of the specific words "gains" and "profits" must be restricted to things of the same kind, *ejusdem generis,* as those specifically enumerated. As Mr. Justice Lurton said in *United States* v. *Stever,* 222 U. S. 167, 174:

> "In such circumstances, unless there is a clear manifestation to the contrary, general words, not specific or limited, should be construed as applicable to cases or matters of like kind with those described by the particular words."

This view is strongly reinforced by the fact that in the same section of the Act of Congress, the provision of section 2 in relation to March first, 1913, speaks only of *gain,* and that no reference is made to profits or income. The maxim *expressio unius est exclusio alterius* would seem to be clearly applicable. The language employed would then exclude "profits and income," if they mean something other or broader than "gains," and must be confined to the single subject of "gains." Such was undoubtedly the intention, for the provision actually reads as follows:

> "(c) For the purpose of ascertaining the *gain* derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

Obviously if the words "net income" in the preceding subdivision (a) of the same section had been intended to mean something different from "gains" and "profits",

the same terminology would have been used and repeated in subdivision (c).

It follows that, if we are to reject the rule of *ejusdem generis* and to hold that by the use of the word "income," as employed in subdivision (a) of section 2, it was intended to reach and cover something different from "gains" or "profits," then it must necessarily follow that *income* other than a *gain* does not come within the purview of subdivision (c) of the same section because the term "income" was not repeated there, and that there was, therefore, no authority to apply the standard of market price or value as of March first, 1913, as distinguished from the market price or value when the plaintiff acquired the stock of the New York Goodrich Company in May, 1912. It would then result that if there was no *gain* at all, but in fact and truth an actual loss or diminution of capital, as in the case at bar, the statutory provision enacted "for the purpose of ascertaining the *gain derived from the sale*," etc., and "determining the amount of such *gain* derived" would not apply.

To hold otherwise would be to re-write the statute in a way quite beyond the power of any court and to attribute to the law-making power an intent which would in many instances be unfair, unjust and oppressive to taxpayers who had received no gain or profit whatever and, indeed, nothing that would come reasonably within the "natural and obvious sense" of the word income authoritatively defined as "the gain derived from capital, from labor, or from both combined" (*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. at p. 185; *Eisner* v. *Macomber*, 252 U. S. at p. 207). The closing clause of the amended

provision, namely, that it "shall be the *basis for determining the amount of such gain derived,*" plainly evidences the idea that the test or standard fixed in the subdivision should apply only where there was a "*gain derived,*" and not where there was actually a loss sustained.

Congress could not arbitrarily create a fictitious "gain," where none in fact existed, in order to levy an income tax on the transaction, when in final analysis such a tax would have to be paid clearly out of diminished capital and therefore be an unapportioned property tax as distinguished from an income tax. To constitute a gain there must, of course, be a realization of profit by sale over the cost of the property when acquired. The two dates—of acquisition and sale—and the value on each of them are essential elements. Congress could not fix an arbitrary date of acquisition so as to charge the taxpayer with a fictitious cost any more than it could fix an arbitrary date of sale or conversion. Plainly, the purpose of the provision in question was to segregate the amount of gain accruing after the adoption of the Sixteenth Amendment from any gain accruing before, only when a gain had actually accrued and been realized.

The fact that the date of March first, 1913, is adopted in the Act of 1916 likewise for the purpose of determining a loss, that is, "the basis for determining the amount of such loss sustained," is immaterial, because the allowance of the deduction of losses actually sustained is wholly a statutory concession, and Congress might, as it did in the Income Tax Act of 1913, c. 16, 38 Stat. 166, limit the losses allowable and exclude altogether as a deduction capital losses not sustained in carrying on a business or trade.

It is submitted that it is reasonably manifest that a construction of the Income Tax Law of 1916 which would practically result in levying a tax upon and measured by what is essentially diminished or reduced capital would be unconstitutional as being in substance and effect a direct tax payable solely in respect of capital or out of the proceeds of capital. At any rate, there are certainly "grave doubts upon that score." In such a case the rule in this court is to avoid a conclusion which might render a statute even of doubtful constitutionality (*United States v. Standard Brewery*, 251 U. S. 210, 220; *United States v. Jin Fuey Moy*, 241 U. S. 394, 401; *United States v. Delaware & Hudson Co.*, 213 U. S. 366), and to adopt a construction which will avoid such doubts, if reasonably permissible. Moreover, equally well-settled is the rule that any doubt as to the intent of a tax law will be resolved in favor of the taxpayer. *Gould v. Gould*, 245 U. S. 151; *Eidman v. Martinez*, 184 U. S. 578, 582-590.

Moreover, it has been the long established practice of this court to limit general terms, such as the word "income" in the case at bar, so as not to lead to injustice, oppression, or an absurd consequence, and to construe a statute according to its spirit and not according to its letter whenever the letter would render it so unjust or oppressive as to warrant the presumption that Congress could not reasonably have intended such a literal following of its language. It is certainly not reasonable to assume that Congress intended to tax as a "gain" what was in fact and truth an actual "loss".

Thus, in *United States v. Kirby*, 7 Wall. 482, 486, Mr. Justice Field defined the rule in the following language:

"All laws should receive a sensible construc-

> tion. General terms should be so limited in their application as not to lead to injustice, oppression, or an absurd consequence. It will always, therefore, be presumed that the legislature intended exceptions to its language, which would avoid results of this character. The reason of the law in such cases should prevail over its letter."

See also *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 414; *Hawaii* v. *Mankichi*, 190 U. S. 197, 212; *Holy Trinity Church* v. *United States*, 143 U. S. 457, 459; *Pickett* v. *United States*, 216 U. S. 456, 461; *Knowlton* v. *Moore*, 178 U. S. 41, 77; *United States* v. *Palmer*, 3 Wheat. 610, 631.

It follows, therefore, that it is reasonably to be presumed that Congress did not intend to levy a tax on anything except "gains" actually received by the taxpayer. The standard of March first, 1913, was adopted and followed solely for the benefit of the taxpayer, so as to exclude "gains" which had accrued prior to that date. Assuming that increase in value of capital investments could be and was intended to be taxed as income, then the clause now in question was a concession to the taxpayer so as to exclude from taxation as income increases in value which had accrued prior to March first, 1913.

Conclusion.

For the reasons indicated above, it is submitted (1) that growth, increment, or accretion in value of property held for investment and then sold is essentially capital and not income, (2) that it was not the intention of Congress to tax such growth, increment, or accretion in value in and by the Act of 1916, and (3) that the test of market price or value on March first, 1913, is applicable only

where there has in fact been a gain, and not where there has been in fact a loss of capital.

The judgment of the court below should, therefore, be reversed.

Washington, February 28, 1921.

William D. Guthrie,
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Of counsel for plaintiff in error.

APPENDIX.

Comparison of Income Tax Acts of 1913 and 1916.

The language of the Act of 1913 omitted in the Act of 1916 is placed in brackets and underscored; the new matter in the Act of 1916 is italicized. Matter common to both acts is in same type.

Act of 1913, (38 Stat. 166).	*Act of 1916, (39 Stat. 756).*
"A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income [arising or accruing from all sources in the preceding calendar year to] every citizen of the United States . . . a tax of 1 per centum [per annum] upon such income . . .; and a like tax shall be assessed, levied, collected, and paid annually upon the entire net income [from all property owned and of every business, trade, or profession carried on in] the United States by [persons residing elsewhere].	"Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income *received* in the preceding calendar year from all sources *by every individual, a* citizen *or resident of the* United States, a tax of *two* per centum upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the entire net income *received in the preceding calendar year from all sources within* the United States by *every individual, a nonresident alien* . . .
B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from	Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from
salaries, wages, or compensation for personal service of whatever kind and in whatever form paid,	salaries, wages, or compensation for personal service of whatever kind and in whatever form paid,
or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or	or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or

personal, growing out of the ownership or use of or interest in real or personal property,

also from interest, rent, dividends, securities, or the transaction of any [lawful] business carried on for gain or profit, or gains or profits and income derived from any source whatever, [including the income from but not the value of property acquired by gift, bequest, devise, or descent]." . . .

personal, growing out of the ownership or use of or interest in real or personal property,

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit,

or gains or profits and income derived from any source whatever, . . .

(b) Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be . . .

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 4. The following income shall be exempt from the provisions of this title:

The proceeds of life insurance policies . . . the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State . . .; the compensation of the present President of the United States . . . and the Judges . . . and the compensation of all officers . . . of a State . . . .

"DEDUCTIONS ALLOWED

"That in computing net income for the purpose of the [normal] tax there shall be allowed as deductions:

Sec. 5. That in computing net income *in the case of a citizen or resident of the United States*

(a) For the purpose of the tax there shall be allowed as deductions

first, the necessary expenses actually paid in carrying on any business * * *

second, all interest paid within the year * * *

third, * * * taxes * * *

fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, [or] shipwreck, [and] not compensated for by insurance or otherwise;"

First. The necessary expenses actually paid in carrying on any business *or trade* * * *

Second. All interest paid within the year * * *

Third, Taxes * * *

Fourth, Losses actually sustained during the year, incurred *in his business or* trade, or arising from fires, storms, shipwreck, *or other casualty, and from theft, when such losses are* not compensated for by insurance or otherwise;"

Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom.

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fifth, debts due to the taxpayer actually ascertained to be worthless and charged off [within] the year.

Sixth. Debts due to the taxpayer actually ascertained to be worthless and charged off *during* the year.

sixth, A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business.

Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business *or trade;*

[Provided, That] no deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate,

[The net income from property owned and business carried on in the United States by persons residing elsewhere shall be computed upon the basis prescribed in this paragraph and that part of paragraph G of this section relating to the computation of the net income of corporations, joint stock and insurance companies, organized, created, or existing, under the laws of foreign countries, in so far as applicable.]

Non-Resident Aliens.

Sec. 6. That in computing net income in the case of a nonresident alien (a) For the purpose of the tax there shall be allowed as deductions—First, The necessary expenses actually paid in carrying on any business or trade within the United States.

Second. The proportion of all interest paid . . . on his indebtedness. . . .

Third. Taxes. . . .

Fourth. Losses actually sustained during the year, incurred in business or trade conducted by him within the United States . . . arising from fires, storms, shipwreck, or other casualty, and from theft . . . Provided,

That for the purpose of ascertaining the amount of such loss or losses sustained in trade, or speculative transactions not in trade, from the same or any kind of property acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss or losses sustained;

[D. The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: Provided, however, that for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for.]

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No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate,

and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

E. . . .
The tax herein imposed upon [annual] gains, profits, and income not falling under the foregoing and not returned and paid by virtue of the foregoing shall be assessed by personal return.

The tax herein imposed upon gains, profits and income not falling under the foregoing, and not returned and paid by virtue of the foregoing, shall be assessed by personal return. . . .

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Text of the Income Tax Acts of the Civil War period, 1861-1867, so far as relevant.

Act of August 5, 1861, 12 Stat. 292, 309:

> "Sec. 49. That, from and after the first day of January next, there shall be levied, collected, and paid, upon the annual income of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere, or from any other source whatever, . . . a tax of three per centum on the amount of such excess . . . above eight hundred dollars. . . ."

In this act the only provision for deductions is as follows:

> "Provided, That, in estimating said income, all national, state, or local taxes assessed upon the property, from which the income is derived, shall be first deducted."

Act of July 1st, 1862, 12 Stat. 432, 473:

> "Sec. 90. . . . That there shall be levied, collected, and paid annually, upon the annual gains, profits, or income of every person residing in the United States, whether derived from any kind of property, rents, interest, dividends, salaries, or from any profession, trade, employment, or vocation carried on in the United States or elsewhere or from any other source whatever . . . a duty of three per centum on the amount of such annual gains, profits, or income . . ."

In this act there is an almost identical provision to that above quoted from the act of 1861 for the deduction of taxes, and a new provision for the deduction of salaries of officers or persons in the service of the United States including senators, representatives and delegates,

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and of interest, dividends, etc. on which tax has been paid at the source.

Act of June 30, 1864, 13 Stat. 223, 281:

> "Sec. 116. . . . That there shall be levied, collected, and paid annually upon the annual gains, profits, or income of every person residing within the United States . . . whether derived from any kind of property, rents, interests, dividends, salaries, or from any profession, trade, employment, or vocation, carried on in the United States or elsewhere, or from any other source whatever, except as hereinafter mentioned . . . a duty of five per centum on the excess over six hundred dollars . . . *And provided, further,* That net profits realized by sales of real estate purchased within the year for which income is estimated, shall be chargeable as income; and losses on sales of real estate purchased within the year, for which income is estimated, shall be deducted from the income of such year."
>
> "Sec. 117. . . . In estimating the annual gains, profits, or income of any person . . . there shall be included and assessed as part of the income of such person for each year . . . all income or gains derived from the purchase and sale of stocks or other property, real or personal, and the increased value of live stock, whether sold or on hand . . ."

In the Act of 1864 there is, in sec. 117, a further provision, similar in language to that in the Act of 1862, for the deduction of taxes, of official salaries, and of income tax paid at the source. A new provision is added for the deduction of rent of premises from which income is derived (p. 282) and of interest on encumbrances thereon, and the amount paid for ordinary repairs, and the provision follows, repeated in all the subsequent acts from that of 1865 to and including the Act of 1918:

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> "But no deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate."

Act of March 3, 1865, 13, Stat. 469, 479:

Sections 116 and 117 of the Act of 1864 were re-enacting (so far as pertinent) in substantially identical language with that above quoted.

Act of March 2, 1867, 14 Stat. 471, 477:

Section 116 of the Act of 1864 as amended by the Act of 1865 was further amended by striking out all after the enacting clause and inserting (478):

> "That there shall be levied, collected, and paid annually upon the gains, profits, and income of every person residing in the United States . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, carried on in the United States, or elsewhere, or from any other source whatever, a tax of five per centum. . . ."

Section 117 was amended by striking out all after the enacting clause and inserting:

> "That in estimating the gains, profits, and income of any person, there shall be included all income derived from interest upon notes, bonds, and other securities of the United States; profits realized within the year from sales of real estate purchased within the year or within two years previous to the year for which income was estimated . . . the amount of all premium on gold and coupons; the amount of sales of live stock, sugar, wool . . . or other vegetable or other productions, being the growth or produce of the estate of such person . . . all other gains, profits, and income derived from any source whatever. . . . And in addition to one thousand dollars exempt from in-

come tax, as hereinbefore provided, all . . . taxes . . . shall be deducted . . . losses actually sustained during the year arising from fires, shipwreck, or incurred in trade, and debts ascertained to be worthless, but excluding all estimated depreciation of values and losses within the year on sales of real estate purchased two years previous to the year for which income is estimated. . . . Provided that no deduction shall be made for any amount paid out for new buildings, permanent improvements or betterments, made to increase the value of any property or estate.''

Appendix.

Debates in Congress, Acts of 1913 and 1916.

On *April 26, 1913*, the Income Tax Bill (H. R. 3321) was before the House of Representatives as Committee of the Whole House on the State of the Union. Cong. Rec., Vol. 50, pt. 1, Apl. 26, 1913. Mr. Hull (the reputed author of the income tax provisions) was explaining the bill in detail and with reference to the Sixteenth Amendment. At *page 513*:

> "*Mr. Hull.* I will say to the gentleman frankly that it has been held in construing all these laws that I have observed, that unless the unearned increment is expressly made income it is not considered income in any sense of the word but simply increase of value or capital. * * *
>
> *Mr. Mann.* What I really wanted to get at was not that, but whether it would relate back so as to cover all profit. Suppose a man bought property many years ago which probably last year was worth as much as it is this year. He sells it this year. What are his profits? How does he arrive at what his profits are?
>
> *Mr. Hull.* My judgment would be that as to an occasional purchase of real estate by one not a dealer or one making the buying and selling a business this bill would only apply to profits on sales where the land is purchased and sold during the same year.
>
> *Mr. Mann.* I hope that statement will remain in the *Record.*"

and at *page 506:*

> "*Mr. Hull.* The rulings of the Treasury Department and the decisions of the courts of this country with respect to similar provisions of the old income tax laws and *also the English rules of construction,* all essential portions of which will be embraced in the Treasury regulations, will make clear the distinction between *taxable profits or income on the one hand and capital or principal on the other.*"

Appendix.

In the *Senate* debates over the Act of 1916 (H. R. Bill No. 16763) the following proceedings appear. On August 26th, 1916, the Senate resumed consideration of the House Bill. (Cong. Rec. Vol. 53, part 13, p. 13262).

In the bill as it passed the House the provision with respect to the basis of ascertaining gains on sales (now subd. (c) *supra,* p. 69) read as follows (p. 13262):

> "(c) Of the gain derived or loss sustained from the sale of real estate, stocks, bonds, securities, or other property, acquired before March 1, 1913, not bought and sold in the course of trade by the taxpayer, only such proportion shall be included as the time between March 1, 1913, and the date of sale bears to the entire time between the date of acquisition and the date of sale."

This provision was stricken out in the Senate without debate and the Senate Committee's amendment adopted, viz.:

> "(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived."

The Senate adopted as a further amendment the following proviso (page 13263, col. 2):

> "Provided, that for the purpose of ascertaining the amount of such loss or losses sustained in trade or speculative transactions not in trade from the same or any kind of property acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such loss or losses sustained."

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The following amendment was offered by the Senate Committee (page 13263):

> "Fifth. In transactions entered into for profit, but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom." (This amendment was adopted in conference and became part of the law.)

Here followed a long debate on the subject between Senators O'Gorman, Williams, McCumber and others in which the question of profits and losses on the sale of capital investments was not discussed but the debate was confined to speculative transactions and ordinary dealings, for example, on the stock market. Finally, the amendment to the amendment was agreed to in the following form:—

> "Fifth. In lawful business transactions entered into but not connected with his regular business or trade, the losses actually sustained therein during the year." (Cong. Rec., p. 13266.)

In the course of the debate above referred to, at page 13264, Senator Williams said:

> "Mr. President, the present law admits of no deductions whatsoever in these cases. We thought that was rather too drastic. These are transactions entered into for profit but not connected with the taxpayer's business or trade. It is intended to provide for speculative profits and speculative losses."

On August 30th, 1916, the debate on the bill (H. R. 16763, was resumed by the Senate as Committee on the Whole, Cong. Rec., Vol. 53, part 13, 64th Cong., 1st Sess., p. 13407) and Senator Clarke of Arkansas offered the following amendment:—

> (c) "For the purpose of ascertaining the gain derived from the sale or other disposition of real

property, the profits realized within the year from the sale or other disposition of any real estate purchased within two years previous to the close of the year for which such income is estimated, shall be the basis for determining the amount of such gain so derived from such sale or other disposition thereof."

Senator Williams, in behalf of the Committee in charge of the bill, then said:—

"With that amendment adopted there ought to be inserted the same amendment where the measure of losses sustained is to be considered because it involves the same question. I, therefore, ask unanimous consent that, if adopted, the same amendment shall be handed to the clerks at the desk by the Senator from Arkansas to be inserted at the other place in the bill where it would be relevant."

"Mr. Chamberlain: I should like to know the purpose of the amendment and why it is offered now after the committee amendment has been adopted."

"Mr. Clarke of Arkansas: I am very glad to explain it. The purpose of the amendment for which this has been substituted was to fix a date when the profits of an investment should cease to be income and become capital. The amendment adopted heretofore fixed March 1, 1913, as that date and made it a permanent date, so that no matter how long this Act might remain in force, that would be the date from which the investment as capital would be considered and all profits intervening would be income. This has been one of the troublesome questions in tax legislation. In 1867 Congress fixed the period within which real estate investments should be treated as income at two years. The matter was brought to the Supreme Court in the case of *Gray* vs. *Darlington*, Fifteenth Wallace, where it was held that profits during the current year were properly treated as income, that if the investment inured for a longer

period it became merged in capital and it was not proper to fix it as income. That feature was carried into the subsequent income tax law down to the one passed in 1894. The last income tax left it out entirely, so that the only part of the profit on real estate investment or any other investment for that matter, which should become profit for the purpose of being treated as income, would accrue within the current year. The purpose of this Act is to adopt as an approved rule two years as against real estate investments, that is to say, investments made in real estate and not consummated by a subsequent sale for a period greater than two years, shall be treated as no part of the income but are to be taken as a part of the loss and profit of that character of transaction and be permitted to pass as increased capital. If a sale occurred any time within the two years, the profit on the transaction would be treated as income and accounted for accordingly. It fixes a date that travels along with the law instead of fixing absolutely a day, which was the first of March, 1913. That would have involved the necessity of making an assessment every time an income-tax return was made with a view of determining whether or not in the meantime some profit had not attached to it. The one is a sensible, forcible rule and the other is an exceedingly inconvenient one which does not in all cases do justice because it might turn out that some investments would produce no profit whatever. No provision is made for taking care of that contingency."

"Mr. Hitchcock: According to what I heard of the amendment read, it differs from the amendment which the Senate adopted also in this respect that the amendment adopted by the Senate includes not only real estate but also personal and mixed property. I should like to know what becomes of the profit on personal or mixed property."

"Mr. Clarke of Arkansas: On personal property any profit made during the current year will be accounted for as income. Profit not made on that

character of property during the year or rather realized by the sale, would not be treated as income. That is the universal rule."

"Mr. Hitchcock: Is there any provision for that in the bill?"

"Mr. Clarke of Arkansas: The first section of the bill provides:

(a) That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual a citizen or resident of the United States, a tax of two percent upon such income.

That language was deemed sufficient in the case of *Gray* vs. *Darlington* and fixed the period of the annual accounting. If the Senator will permit me I will read the syllabus in that case which will make much clearer than I have been able to do, the point I am seeking to present to the Senate.

It is the case of *Gray* vs. *Darlington* reported in Fifteenth Wallace, page 63:

The advance in the value of personal property during a series of years does not constitute the gains, profits or income of any one particular year of the series although the entire amount of the advance be at one time turned into money by a sale of the property. Accordingly when bonds of the United States were sold by the owner, after being held by him four years, at an advance of Twenty thousand dollars over their cost to him, it was held that this amount was not taxable as 'gains, profits or income' for the owner for the year in which the sale was made under the Amendatory Internal Revenue Act of March 2, 1867 * * * At page 66 the Court said:

> The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital.

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That is my answer to the inquiry of the Senator from Nebraska."

"Mr. Hitchcock: I still am not able to understand it. I will put a case to the Senator. Suppose a man has purchased in a certain year stocks or bonds and two years thereafter there is an advance of $20,000. Is the man just taxed for one year only on the profit made?"

"Mr. Clarke of Arkansas: He is not taxed at all on that because it ceases to be income and becomes capital."

"Mr. Hitchcock: What reason is there for taxing the man upon the profit he makes upon the sale of real estate within two years and not taxing him upon the profit he makes on the purchase and sale of securities?"

"Mr. Clarke of Arkansas: That always has been carried as a discrimination in the law. Whatever my opinion is it ought to be confined to the annual accounting. There is no necessity really for making a distinction against real estate but it always has been made and I thought it would be a preferable rule to the one the committee adopted."

"Mr. Williams: Real estate is not a live asset and is not generally bought and sold within one year."

"Mr. Hitchcock: I do not think that answers the question at all. Why should we exempt from the income tax the profit a man makes upon the purchase and sale of stocks and bonds? Why should they not be included with real estate just as they were originally included in this paragraph?"

"Mr. Clarke: They are included now if the purchase and sale is made within a year. That is the law. The Supreme Court of the United States answered that question and held that it is a part of his capital and a tax cannot be levied upon it."

"Mr. Hitchcock: I am at a loss to see why the increase in the value of real estate is not a part of the capital."

Appendix.

"Mr. Clarke of Arkansas: That matter may be decided some day and determined to the contrary, but at present the decision of the Supreme Court seems to treat it as a valid provision. There are numerous grounds upon which the distinction between real and personal property can be established where one rule of taxation applies in one case and another in another. Bonds pass very frequently and very rapidly, many times, whereas as the Senator from Mississippi suggests, that is not the rule in the case of real property."

"Mr. Hitchcock: It seems to me we are proposing to exempt from taxation some or most of the enormous profits made in this country. For instance during the last year or two perfectly prodigious incomes have been derived by men through successful speculation in the purchase and sale of stocks and bonds and the incomes derived from the purchase and sale of real estate are insignificant by comparison. I do not like to assent to exempting these profits while continuing to tax profits on real estate."

"Mr. Clarke of Arkansas: The Senator misunderstands me if he thinks I am trying to exempt their profits from taxation. I simply want to establish a rule that applies in every other character of taxation provided for in this bill and that is the annual accounting. That is what was done in this particular case. The tax collector in New York collected an income tax of $20,000 upon an increase on bonds that the taxpayer had been holding for four years. He paid the tax under a protest and sued the collector for it and that is the way this particular lawsuit was decided and like every other lawsuit will be decided— . . ."

"Mr. Chamberlain: I am frank to say I really do not understand the effect of this amendment. There was a good deal of discussion over this particular amendment, I will say to the Senator, and it involves two other amendments which I supposed, and those who think with me on the subject supposed, had been settled. This seems to change

the whole proposition and before it is acted upon I should like to have the matter go over until tomorrow, it involving three amendments as I suggested."

"Mr. Clarke of Arkansas: I have no objection to that course. The matter was submitted to the Senator from Alabama (Mr. Underwood) who proposed the amendment which is now offered as a substitute."

"Presiding Officer: Is there objection to postponing the consideration of this question until tomorrow?

"Mr. Williams: I have no objection, although I wish it could be disposed of now. The Senator from Alabama who drew the amendment which is upon the bill now has agreed to this amendment to the amendment. I think the amendment to the amendment helps the amendment itself very much but I have no objection to its going over.

"The Presiding Officer: If there is no objection, it will be postponed until tomorrow."

The subsequent debates in the Senate and the House of Representatives do not appear to throw any light upon the intention of Congress in regard to capital profits.